Rai Technology University

ENGINEERING MINDS

Elements of Financial Services

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Subject: ELEMENTS OF FINANCIAL SERVICES **Credits: 4**

SYLLABUS

Financial Services

Introduction, A conceptual framework, Scope and classification, the financial system and its functions, Classification of Financial markets, Development of financial system in India

Non Banking Financial Companies

Introduction, Regulatory Non- Banking Companies (RNBCs), RBI act framework, RBI acceptance of public deposits directions, RBI NBFCs Prudential Norms, Norms related to Auditors report, Latest RBI/Ministry of finance guidelines.

Fund based financial Services Concept

of Lease financing, Theoretical and regulatory framework of leasing in India, Lease documentation and agreement, Concept of Hire purchase finance, Conceptual and legal framework, Hire purchase- Accounting, reporting and taxation, Various forms of credit, Concept of factoring, Types and methodology, Advantages and its limitations, Factoring and forfeiting- Financial evaluation, Bills discounting concept and regulations.

Venture Capital Financing

Concept of venture capital, Origin and types, Stages of investment financing, Factors affecting investment decisions, Selection of venture capitalists, National and International scenario of venture capital financing, SEBI regulations, Corporate venturing.

Insurance Services

Concept of Insurance, Development in India, Regulatory framework of insurance, Insurance regulatory and development authority IRDA, rural obligations, insurance advertisements and disclosure, licensing of insurance agents, general insurance, IRDA act. Reinsurance business and its regulations, Insurance services in India, operations of private insurance companies

Mutual Funds

Concept of Mutual funds, Its development in India, Benefits of Mutual funds, Mutual fund schemes, Working of mutual funds with respect to UTI, SEBI Regulations, , Association of mutual funds in India, Unit Trust of India, Growth and performance of mutual funds in India.

Suggested Readings:

1. Management of Financial Services by Bhalla VK, Anmol publishing house
2. Financial Services by Khan MY, Tata McGraw Hill
3. Indian Financial System by Machiraju, Vikas Publishing house
4. Indian Financial System by Pathak, Bharati V, Pearson education.
5. Indian Financial System by Khan MY, Tata McGraw Hill

MANAGEMENT OF FINANCIAL SERVICES

COURSE OVERVIEW

For students of business administration specializing in finance it is very important to understand the financial services in detail. Since there are various services and variety of organization and intermediaries in the business, it becomes essential to tell them in detail about them. Since aspiring managers may go into jobs at these financial intermediaries, knowledge of their management and working will help them in working.

Financial services sector is under strict control of the SEBI, RBI and Ministry of Finance, GOI it is essential to keep them updated on the latest in the financial services sector requirements.

The aim of this subject is to develop students' understanding of the management and administration of financial services and intermediaries providing them. In particular the subject is designed to develop the knowledge and up to date information required to make informed decisions in today's fast-paced business environment.

In today's competitive business environment, we need dependable and pertinent information. This subject hence equips the students with deeper understanding. This subject prepares the students with the in-dept knowledge of various form of financial services and government regulations, business ethics in these services, syndication of services etc.

The students on completion of the course shall develop the following skills and competencies:

a) Various forms of financial services
b) Fund based services, providers of such services and management of such Organizations
c) Fee based services, services providers and their management
d) SEBI and RBI guidelines/regulations for the various intermediaries and services
e) Capital markets and marketing of financial instruments/ services.

ELEMENTS OF FINANCIAL SERVICES
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LESSON 33
ISSUE MANAGEMENT: ISSUE RELATED ACTIVITIES AND SEBI GUIDELINES

Lesson Objectives: **To understand the process of issue management and SEBI guidelines related to issue management activity.**

INTRODUCTION

Issue management, now days, is one of the very important fee based services provided by the financial institutions. In recent past various companies have entered into issue management activities. Still there are very few large scale and specialized issue management agencies in the country. With the growth of stock market and opening up of economy, the scope for issue management activity is widening day by day. To protect the investors' interest and for orderly growth and development of market, SEBI has put in place guidelines as ground rules relating to new issue management activities. These guidelines are in addition to the company law requirements in relation to issues of capital / securities.

Financial instruments can be classified into two main groups – share capital and debt capital. There are various other classifications in each of the two categories. Also, there are various types of company's i.e. listed, unlisted, public, private etc. For each of them SEBI has issued comprehensive guidelines, related to issue of financial instruments.

Let us discuss all these issue management activities in detail, one by one.

ELIGIBILITY NORMS:

To make an issue, the company must fulfill the eligibility norms specified by SEBI and Companies Act. The companies issuing securities through an offer document, that is (a) prospectus in case of public issue or offer for sale and (b) letter of offer in case of right issue, should satisfy the eligibility norms as specified by SEBI, below:

Filing of Offer Document: In the case of a public issue of securities, as well as any issue of security, by a listed company through rights issue in excess of Rs. 50 lakh, a draft prospectus should be filed with SEBI through an eligible registered merchant banker at least 21 days prior to filing it with ROC. Companies prohibited by SEBI, under any order/direction, from accessing the capital market cannot issue any security.

The companies intending to issue securities to public should apply for listing them in recognized stock exchange(s). Also, all the issuing companies must (a) enter into an agreement with a depository registered with SEBI for dematerialization of securities already issued / proposed to be issued and (b) give an option to subscribers / shareholder / investors to receive security certificates or hold securities in a dematerialized form with a depository.

Public issue / Offer for sale by Unlisted Companies: An unlisted company can make a public issue / offer for sale of equity shares / security convertible into equity shares on a late date if it has in three out of preceding five years (a) a pre issue net worth of Rs. 1 crore (b) a track record of distributable profit in terms of Sec. 205 of the Companies

LESSON 28
DEVELOPMENT FINANCIAL INSTITUTIONS: AN INTRODUCTION

Lesson Objectives: **To understand the working of Development finance institutions, their role in industrial development, Governments policy for DFIs.**

INTRODUCTION

The economic development of any country depends on the extent to which its financial system efficiently and effectively mobilizes and allocates resources. There are a number of banks and financial institutions that perform this function; one of them is the development bank. Development banks are unique financial institutions that perform the special task of fostering the development of a nation, generally not undertaken by other banks.

Development banks are financial agencies that provide medium- and long-term financial assistance and act as catalytic agents in promoting balanced development of the country. They are engaged in promotion and development of industry, agriculture, and other key sectors. They also provide development services that can aid in the accelerated growth of an economy.

The objectives of development banks are:

(i) to serve as an agent of development in various sectors, viz. industry, agriculture, and international trade
(ii) to accelerate the growth of the economy
(iii) to allocate resources to high priority areas
(iv) to foster rapid industrialization, particularly in the private sector, so as to provide employment opportunities as well as higher production
(v) to develop entrepreneurial skills
(vi) to promote the development of rural areas
(vii) to finance housing, small scale industries, infrastructure, and social utilities

In addition, they are assigned a special role in:

(i) planning, promoting, and developing industries to fill the gaps in industrial sector
(ii) coordinating the working of institutions engaged in financing, promoting or developing industries, agriculture, or trade
(iii) rendering promotional services such as discovering project ideas, undertaking feasibility studies, and providing technical, financial, and managerial assistance for the implementation of projects

EVOLUTION OF DEVELOPMENTAL BANKS

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads, viz.

a. Fund based activities and
b. Non-fund based activities.

Fund based activities: The traditional services which come under fund based activities are the following:

i. Underwriting or investment in shares, debentures, bonds, etc. of new issues (primary market activities).
ii. Dealing in secondary market activities.
iii. Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.
iv. Involving in equipment leasing, hire purchase, venture capital, seed capital.
v. Dealing in foreign exchange market activities.

Non fund based activities: Financial intermediaries provide services on the basis of non-fund activities also. This can be called 'fee based' activity. Today customers, whether individual or corporate, are not satisfied with mere provisions of finance. They expect more from financial services companies. Hence a wide variety of services, are being provided under this head. They include:

i. Managing the capital issue – i.e. management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issue.
ii. Making arrangements for the placement of capital and debt instruments with investment institutions.
iii. Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.
iv. Assisting in the process of getting all Government and other clearances.

Modern Activities:

Beside the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder.

i. Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approvals.
ii. Planning for M&A and assisting for their smooth carry out.
iii. Guiding corporate customers in capital restructuring.
iv. Acting as trustees to the debenture holders.
v. Recommending suitable changes in the management structure and management style with a view to achieving better results.
vi. Structuring the financial collaborations / joint ventures by identifying suitable joint venture partners and preparing joint venture agreements.
vii. Rehabilitating and restructuring sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.

viii. Hedging of risks due to exchange rate risk, interest rate risk, economic risk, and political risk by using swaps and other derivative products.
ix. Managing the portfolio of large Public Sector Corporations.
x. Undertaking risk management services like insurance services, buy-back options etc.
xi. Advising the clients on the questions of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.
xii. Guiding the clients in the minimization of the cost of debt and in the determination of the optimum debt-equity mix.
xiii. Undertaking services relating to the capital market, such as
    a. Clearing services
    b. Registration and transfers,
    c. Safe custody of securities
    d. Collection of income on securities
xiv. Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

SOURCES OF REVENUE:

There are two categories of sources of income for a financial services company, namely: (i) Fund based and (ii) Fee – based.

Fund based income comes mainly from interest spread (the difference between the interest earned and interest paid), lease rentals, income from investments in capital market and real estate. On the other hand, fee based income has its sources in merchant banking, advisory services, custodial services, loan syndication, etc. In fact, a major part of the income is earned through fund-based activities. At the same time, it involves a large share of expenditure also in the form of interest and brokerage. In recent times, a number of private financial companies have started accepting deposits by offering a very high rate of interest. When the cost of deposit resources goes up, the lending rate should also go up. It means that such companies have to compromise the quality of its investments.

Fee based income, on the other hand, does not involve much risk. But, it requires a lot of expertise on the part of a financial company to offer such fee-based services.

CAUSES FOR FINANCIAL INNOVATION:

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with the increasingly volatile and uncertain market place. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons:

i. Low profitability: The profitability of the major FI, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.
ii. Keen competition: The entry of many FIs in the financial sector has led to severe competition among them. This keen competition has paved the way for

the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

iii. Economic Liberalization: Reform of the Financial sector constitutes the most important component of India's programme towards economic liberalization. The recent economic liberalization measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

iv. Improved communication technology: The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities.

v. Customer Service: Now a day, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public.

vi. Global impact: Many of the providers and users of capital have changed their roles all over the world. FI have come out of their traditional approach and they are ready to assume more credit risks.

vii. Investor Awareness: With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds, etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovations has become the need of the hour.

Financial Engineering:

The growing need for innovation has assumed immense importance in recent times. This process is being referred to as financial engineering. 'Financial engineering is the design, development and implementation of innovative financial instruments and process and the formulation of creative solutions to the problems in finance'.

NEW FINANCIAL PRODUCTS AND SERVICES:

In these days of complex finances, people expect a financial service company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporate and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial services company to innovate new products and services so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety

of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are briefly explained hereunder:

i. Merchant Banking: A merchant banker is a financial intermediary who helps to transfer capital from those who possess it to those who need it. Merchant banking includes a wide range of activities such as management of customer securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporate, and thus promote industrial development in the country.

ii. Loan Syndication: This is more or less similar to consortium financing. But this work is taken up by the merchant banker as a lead manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a government department. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

iii. Leasing: A lease is an agreement under which a company or a firm acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called 'rental charges'. In countries like USA, the UK and Japan, equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business.

iv. Mutual Funds: A mutual fund refers to a fund raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing the risk. The fund provides investment avenues for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capitalization in the long run.

v. Factoring: Factoring refers to the process of managing the sales register of a client by a financial services company. The entire responsibility of collecting the book debts passes on to the factor.

vi. Forfeiting: Forfeiting is a technique by which a forfeiter (financing agency) discounts an export bill and pays ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills.

vii. Venture Capital: A venture capital is another method of financing in form of equity participation.

viii. Custodial Services: Under this a financial intermediary mainly provides services to clients, for a prescribed fee, like safe keeping of financial securities and collection of interest and dividends.

ix. Corporate advisory services: Financial intermediaries particularly banks have setup specialized branches for this. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers; this service is of immense help to the customers.

x. Securitization: Securitization is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable.

xi. Derivative Security: A derivative security is a security whose value depends upon the values of other basic variable backing the security. In most cases, these variables are nothing but the prices of traded securities.

xii. New products in Forex Markets: New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them are:
   a. *Forward contract:* A forward transaction is one where the delivery of foreign currency takes place at a specified future date for a specified price. It may have a fixed or flexible maturity date.
   b. *Options:* As the very name implies, it is a contract where in the buyer of options has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his options.
   c. *Futures:* It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange.
   d. *Swaps:* A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates.

xiii. Lines of Credit: It is an innovative funding mechanism for the import of goods and services on deferred payments terms. LOC is an arrangement of a financing institution of one country with another to support the export of goods and services to as to enable the importer to import on deferred payment terms.

CHALLENGES FACING THE FINANCIAL SERVICES SECTOR:

Though financial services sector is growing very fast, it has its own set of problems and challenges. The financial sector has to face many challenges in its attempt to fulfill the ever-growing financial demands of the economy. Some of the important challenges are briefly explained hereunder:

i. Lack of qualified personnel: The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. The dearth of qualified and trained personnel is an important impediment in its growth.

ii. Lack of investor awareness: The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments.

iii. Lack of transparency: The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner.

iv. Lack of specialization: In the Indian scene, each financial intermediary seems to deal in a different financial service lines without specializing in one or two areas. In other countries, financial intermediaries specialize in one or two areas only and provide expert services.

v. Lack of recent data: Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon 'financial creativity'.

vi. Lack of efficient risk management system: With the opening of the economy to multinationals and exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

PRESENT SCENARIO:

The Indian economy is in the process of rapid transformation. Reforms are taking place in every field / part of economy. Hence financial services sector is also witnessing changes. The present scenario can be explained in following terms:

i. Conservatism to dynamism: The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. At present numerous new FIs have started functioning with a view to extending multifarious services to the investing public in the area of financial services.
ii. Emergence of Primary Equity Market: The capital markets, which were very sluggish, have become a very popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. After the lowering of bank interest rates, capital markets have become a very popular mode of channelising the savings of medium class people.
iii. Concept of Credit Rating: The investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now grading from an independent agency would help the investors in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company's point of view, Equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments.
iv. Process of globalization: The process of globalization has paved the way for the entry of innovative and sophisticated products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentialities for the introduction of innovative, international financial products in India are very great. Moreover, our country is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.
v. Process of liberalization: Our government has initiated many steps to reform the financial services industry. The government has already switched over to free pricing of issues by the CCI. The interest rates have been deregulated.

The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. SEBI has liberalized many stringent conditions so as to boost the capital and money markets.

LESSON 2
THE FINANCIAL SYSTEM

LESSON OBJECTIVES: TO UNDERSTAND THE FUNCTIONS OF FINANCIAL SYSTEM, FINANCIAL ASSETS, INTERMEDIARIES AND MARKETS.

The economic development of any country depends upon the existence of a well organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promotes the well being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system.

The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilize the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

FUNCTIONS OF THE FINANCIAL SYSTEM

As we know, financial system is very important for the economic and all round development of any country, its major functions can be explained as following:

1. Promotion of Liquidity:

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. In other words, the liquidity refers to cash or money and other assets which can be converted into cash readily without loss. Hence, all activities in a financial system are related to liquidity – either provision of liquidity or trading in liquidity.

2. Mobilization of Savings:

Another important activity of the financial system is to mobilize savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

FINANCIAL CONCEPTS

An understanding of the financial system requires an understanding of the following concepts:

1. Financial Assets
2. Financial Intermediaries
3. Financial markets

4. Financial rates of returns
5. Financial instruments

FINANCIAL ASSETS:

In any financial transaction, there should be a creation or transfer of financial asset. Hence, the basic product of any financial system is the financial asset. A financial asset is one, which is used for production or consumption or for further creation of assets. For instance, A buys equity shares and these shares are financial assets since they earn income in future.

One must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning incomes. It is interesting to note that the objective of investment decides the nature of assets. For instance, if a building is bought for residence purposes, it becomes a physical asset, if the same is bought for hiring it becomes a financial asset.

Classification of Financial Assets:

Financial assets can be classified differently under different circumstances. Like:

A. (i) Marketable assets and (ii) Non-marketable assets
B. (i) Money/cash asset (ii) Debt asset and (iii) Stock assets

Marketable Assets: Marketable assets are those which can be easily transferred from one person to another without much hindrance. Example – Equity shares of listed companies, Bonds of PSUs, Government Securities.

Non-marketable Assets: If the assets cannot be transferred easily, they come under this category. Example: FDRs, PF, Pension Funds, NSC, Insurance policy etc.

Cash Assets: All coins and currencies issued by the Government or Central Bank are cash assets. Besides, commercial banks can also create money by means of creating credit.

Debt Asset: Debt asset is issued by a variety of organizations for the purpose of raising their debt capital. There are different ways of raising debt capital. Ex.- issue of debentures, raising of term loans, working capital advances etc.

Stock Asset: Stock is issued by business organizations for the purpose of raising their fixed capital. There are two types of stock namely equity and preference.

FINANCIAL INTERMEDIARIES:

The term financial intermediaries include all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers. Thus, it refers to all kinds of FIs and investing institutions which facilitate financial transactions in financial markets. They may be in the organized sector or in the unorganized sector. They may also be classified in to two:

(i) Capital Market Intermediaries
(ii) Money Market Intermediaries.

Capital Market Intermediaries:

These intermediaries mainly provide long term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investment institutions like LIC.

Money market intermediaries:

Money market intermediaries supply only short term funds to individuals and corporate customers. They consist of commercial banks, cooperative bank.

FINANCIAL MARKETS:

Generally speaking, there is no specific place or location to indicate a financial market. Wherever a financial transaction takes place it is deemed to have taken place in the financial market. Hence financial markets are pervasive in nature since financial transactions are themselves very pervasive throughout the economic system. However, financial markets can be referred to as those centers and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

CLASSIFICATION OF FINANCIAL MARKETS:

The classification of financial markets in India can be as following:

Unorganized Markets: In unorganized markets, there are a number of money lenders, indigenous bankers, traders, etc. who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc whose activities are not controlled by the RBI. The RBI has already taken some steps to bring unorganized sector under the organized fold.

Organized Markets: In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrumentalization. These markets are subject to strict supervision and control by the RBI or other regulatory bodies. These organized markets can be further classified into two. They are

(i) Capital Market and
(ii) Money Market.

Capital Market:

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three, namely:

1. Industrial Securities Market
2. Government Securities Market and
3. Long-term Loans Market.

1. Industrial Securities Market

As the very name implies, it is a market for industrial securities, namely: (i) equity shares (ii) Preference shares and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are

a. Primary market or New Issue Market,
b. Secondary market or Stock Exchange.

Primary Market: Primary market is a market for new issues or new financial claims. Hence it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation.

There are three ways by which a company may raise capital in a primary market. They are (i) Public issue (ii) Right issue and (iii) Private placement.

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to

raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

Secondary Market: Is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government.

2. Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where government securities are traded. In India there are many kinds of Government securities – short term and long term. Long-term securities are traded in this market while short term securities are traded in money market.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

3. Long-term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long term loans market may further be classified into – (i) Term loans, (ii) Mortgages and (iii) Financial Guarantees markets.

LESSON 3
DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

LESSON OBJECTIVES: TO UNDERSTAND THE GROWTH AND DEVELOPMENT OF FINANCIAL SERVICES IN INDIA

At the time of Independence in 1947, there was no strong financial institutional mechanism in the country. There was absence of issuing institutions and non-participation of intermediary financial institutions. The industrial sector also had no access to the savings of the community. The capital market was very primitive and shy. The private as well as the unorganized sector played a key role in the provision of 'liquidity'. On the whole, chaotic conditions prevailed in the system. Only after the launching of planning era some serious attention was paid to development of a sound financial system in India.

With the adoption of the theory of mixed economy, the development of the financial system took a different turn so as to fulfill the socio-economic and political objectives. The government started creating new financial institutions to supply finance both for agricultural and industrial development and it also progressively started nationalizing some important financial institutions so that the flow of finance might be in the right direction.

The development of financial system in India can be discussed in following headlines. Nationalization of Financial Institutions: Reserve Bank of India, which was started as a private institution in 1935, was nationalized by the Government in 1948 and given the controlling authority of the financial system. Later on various other large financial institutions like banks and insurance companies were nationalized to avoid the concentration of economic power. Starting of Unit Trust of India: Another landmark in the development of Indian financial system was starting of UTI in 1964 as a public sector institution to mobilize small savings for corporate / large ventures. UTI is country's largest and oldest mutual fund. Later on various financial institutions and private sector companies started mutual funds to mobilize public deposits.

Establishment of Development Banks: Many development banks were started not only to extend credit facilities to financial institutions but also to render advisory services. These banks were multipurpose institutions which provide medium and long term credit to industrial undertakings, discover investment projects, undertake the preparation of project reports, provide technical advice and managerial services and assist in the management of Industrial units. Among them are IFCI (1948), ICICI (1955), RCI (1958), IDBI (1964), IRCI (1971), IRBI (1997) and SIDBI (1990) are important DFIs.

Institutions for Financing Agriculture, Foreign Trade and Housing: The Government took serious steps to provide sector specific finance facilities. RBI established ARDC (1963) and NABARD (1982), EXIM Bank (1982) and NHB (1988). Recently in 1987

Stock Holding Corp. of India Ltd. was set up to tone up the stock and capital markets in the country.

Venture Capital Institutions: Venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. The IDBI venture capital fund was set up in 1986. The Risk Capital and Technology Finance Corp. was started by IFCI. Likewise ICICI and UTI jointly setup TDICI in 1988.

Credit Rating Agencies: Of late, many credit rating agencies have been established to help investors to make a decision of their investment in various instruments and to protect them from risky ventures. At the same time it has the effect of improving the competitiveness of the companies so that one can excel the other. Credit rating is now mandatory for all debt instruments.

Multiplicity of Financial Instruments: The expansion in size and number of FIs has consequently led to a considerable increase in the financial instruments also. Different types of instruments are available in the financial system so as to meet the diversified needs of the various people.

Legislative support: The Indian financial system has been well supported by suitable legislative measures taken by the Government then and there for its proper growth and smooth functioning. The Indian Companies Act, 1956, Securities Contacts (Regulation) Act, 1956, MRTP Act, 1970, SEBI Act are few examples of legislative support available to financial system. Apart from the above act,

WEAKNESS OF INDIAN FINANCIAL SYSTEM

After the introduction of planning, rapid industrialization has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing demand of the Government and Industries, many innovative financial instruments have been introduced. The Indian financial system is now more developed and integrated today than what it was few years ago. Yet it suffers from some weaknesses. Let us discuss these weaknesses in detail.

i. Lack of Coordination between different Financial Institutions: There are a large number of FIs. Most of the vital FIs are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of co-ordination arises. As there is multiplicity of institutions in the Indian Financial system, there is lack of coordination in the working of these institutions.
ii. Monopolistic Market Structures: In India, some FI's are so large that they have created a monopolistic market structure of financial system. For instance, almost entire life insurance business is in the hands of LIC of India. So large structures could retard development of financial system of the country itself.
iii. Dominance of Development Banks in Industrial Financing: The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the FI created by the government, both at the national and regional levels. As such, they fail to mobilize the savings of the public.

However, in recent times attempts have been made to raise funds from public through the issue of bonds, units, debentures and so on.

iv. Inactive and Erratic Capital Market: The Indian capital market is not strong and dependable. Because of regular scams and frauds, general public is not having faith in the Capital Markets. The weakness of the capital market is a serious problem in our financial system.

v. Imprudent Financial Practices: The dominance of development banks has developed imprudent financial practice among corporate customer. The development banks provide most of the funds in the form of term loans. So there is a predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided.

However in recent times, all efforts have been made to activate the capital market. Integration is also taking place between different FIs. Similarly, the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian Financial System is undergoing fast changes, to become a well developed one.

REGULATION OF THE FINANCIAL SECTOR – FREEDOM OF THE REGULATOR

By - N. Rangachary, Chairman, IRDA, 23 April 2003

'Which way should I take?' asked Alice.
'It all depends on where you want to go.' replied the rabbit.
− Alice in Wonderland by Lewis Carroll

Introduction

I am delighted to be here among many affectionate friends. I am thankful to Shri M.Narasimham, Chairman, Administrative Staff College Of India, Hyderabad and the author of economic reforms in this country to have asked me to deliver this lecture. I am happy that Administrative Staff College of India has now my friend Dr. E.A.S.Sarma directing it. I consider it a privilege to be talking to you in a subject of my choice. I deliberated deeply for a little while on what I should talk today. Convinced that the financial sector of which I am a part today has still some way to go to be fully reflective of the reforms that one should like to see. I chose the subject of regulation of the financial sector. It is coincidental that Shri K.L.N.Prasad, on whose memory this lecture has been arranged, was also connected to this sector.

In this heterogeneous time of modernity the altering of the boundaries between a state and its market encompasses, what is variously described as, realigning government, structural reforms towards liberalisation or deregulation, and a change of mix of the mixed economy. To enable an appreciation of this changing mix between State and market in India, a combination of descriptive and analytical approaches is adopted in this address, with a focus on what may be described as relevant functions, processes and balances.

In the year 1990-91 which nominally marks the high water-mark of economic reforms in this country, a de-professionalised intellectual saw for the first time in organised manner recognition of systemic problems, particularly in the areas of fiscal, public enterprises and overall competitive strength of industry. It also became clear to the

policy makers that growth financed by unsustainable fiscal as well as trade deficits lacked institutional underpinning to take the economy to a higher growth path or ensure social justice. Given the fiscal situation, the public enterprises which saw the fiscal support drying up started clamoring for market access, autonomy and even some privatisation. The private sector, including the corporate sector, realised that the capacity of Government to support them was getting eroded due to fiscal compulsions, while regulatory and other demands from Government continued to be perceived as a burden on them. In the absence of fiscal support from Government, they found it worthwhile to seek deregulation and liberalisation, arguing against what they described as over-regulation and under-governance. There was a widespread realisation that the basic assumption of efficiency and effectiveness of State vis-à-vis market appear to be less valid than before, mainly due to technological progress and the institutional characteristics of public sector. The success of alternate models elsewhere, in achieving both higher growth and social justice was impressive and sustained, and was too apparent to be ignored by the public opinion in India.

Redrawing the Boundaries

In the functional approach to the role of the State in the late 'eighties, it was argued that redrawing the boundaries between State and market could be analysed in terms of different roles of State. State's role in economic activity can be broadly classified into that of a Producer-State, i.e. producer of commercial goods and services; Regulatory-State, involving setting and enforcing of rules that govern, encourage or discourage economic activities of market participants; Facilitator-State, involving provision of public goods such as police, judiciary, street lighting; and a Welfare State, ensuring a provision of a wide variety of merit goods such as education and health.

As a producer of commercial goods and services, the major option exercised by the Government was to permit entry of private sector in activities that were reserved for public ownership. This option does not necessarily involve retreat of State in absolute terms though in relative terms, it does amount to it.

While attempts were on to reduce the role of State as a 'producer', correspondingly, there has been deregulation in some and expansion of State in others as a regulator. For example, in capital markets, insurance, telecommunications, electricity and ports national level regulatory authorities under appropriate statutes have been established. Similar initiatives are being considered in some other sectors also. The regulatory authorities are expected to exercise independence from the ministries of the Government or the enterprises concerned and provide a broad framework for entry and operating conditions, especially tariff, in a way that would ensure protection and to build the confidence of the investors and consumers, whose interests often get ignored in a monopoly-like situation.

Though at a macro-level there has been deregulation, it is often argued institutional intolerance is undermining the full impact of deregulation. The process of expanding the regulatory role is sometimes described as incomplete, if not inadequate, on the ground that the constitution of regulatory authorities is not necessarily apolitical or designed to counter political cycles; that they are being undermined by Ministries concerned either on account of the narrow and sectarian interests of the public

enterprises or to serve what the Ministry perceives to be a larger public interest, and that the regulatory authorities are inadequately provided for, in regard to physical, financial or human resources, to perform their task efficiently and effectively.
However, it is undeniable that, a basic framework for a more transparent, accountable and, expanded role of State as a regulator has been put in place in many crucial sectors, though a focused attention to the strengthening of these authorities may still be necessary.

In its role as a facilitator State in India, the major thrust is to ensure provision of a public-good that is relevant and not necessarily whether State does it on its own or through use of private sector. For example, health services for an accident victim may be a 'public good' while health services for a by pass surgery is a pure commercial good. It must be recognised that a significant part of provision of public goods falls in the jurisdiction of state governments and not in Central Government. Overall, there is a significant scope and a need for review of the state's role as facilitator.

While in some developed countries, a major source of fiscal stress and consequently a major area of reform has been revamping or cutting down on role of State as a Welfare State, in India there is a large consensus on expanding rather than contracting the role of the State in the provision of welfare. The consensus covers entitlements such as medical attention and old age pensions. Some states are attempting to overcome this through effective decentralisation of initiatives and management. Improvements to inefficient provision by public sector and a regulatory framework to govern unbridled private sector in addition to evolving appropriate mix of funding and provision by public and private partnerships appear to be the reform agenda for the future in the realm of State as welfare provider.

Thus the expectations from reforms in India are not in terms of across the board retreat of State in favor of market but, in terms of enhancing States' capacity to permit efficiency-gains and expand availability of public and merit goods. While State is retreating in some areas, such as pure commercial goods or services, it is both retreating and expanding in other areas such as regulations and is expected to expand further in public and merit goods. In general, the direction of reform is a retreat as a producer State and a retreat coupled with expansion as a regulatory State.
New Equilibrium

The evolution of the mix between State and market in India, during the recent reforms, reveals many interesting aspects, especially on the nature of changing mix relevant to us, as also the variety of options exercised. To assess the dynamics of the changing mix, it would be useful to track what may be termed as new equilibrium levels that are emerging as both causes and consequences of a changing mix between State and market. The changing balance between State and market does not happen in isolation, but is related to other factors as well.

As reform progresses, it appears that the relative balance between Centre and state tends to tilt in favor of states. The most important areas for the Central Government's responsibilities are in international trade, financial sector, telecommunications, aviation, and especially banking and corporate law/practices. In most of these areas,

factors such as multilateral agreements (say GATS), globalisation, and recommended best practices of the world, tend to get constrained, over a period, since the free and rapid flow of commodities, skills and finances among the countries would require us to be not too much out of alignment.

The balance between the Ministries representing the combination of political executive and Government bureaucracy's vis-à-vis the exercise of ownership functions as well as regulatory functions may also change somewhat adverse to Ministries. The process of privatisation, diversified ownership and autonomy of public enterprises may erode the discretionary element of the Ministries. Once separate regulatory bodies on a statutory basis are established and strengthened, they are meant to be autonomous and report to Parliament through an administrative ministry. Often, their membership need not coincide with political cycles and thus may impart greater stability to regulatory regime. Increasing role of semi-autonomous regulatory bodies tilts the balance away from the Ministries and in favour of less volatility in policies.

The relationship among public enterprises and between public and private enterprises could be subject to new balances in several ways. Public enterprise will have to reckon with growing competition from private sector. Regulatory agencies as part of their charter insist on a level playing field between public and private sectors. The public enterprises faced with hard budget constraints, antiquated and non-responsive business practices and procedures, threat of private sector entry and accountability to the new private shareholders where they exist, may have to carve out a new pattern of relationships with the Government and within the organisation.

Strategic cooperation and cross holdings between public and private sectors are inevitable, thus replacing water tight compartmentalisation between them. In fact, this process may necessitate ultimately in the termination of the concept of government companies under Companies Act. The evolution of new balances between public and private sectors is clearly in the horizon. There are large areas, like healthcare, where a public-private mix is dictating new balances, in regard to ownership, funding, official recognition and governmental regulation. The traditional water tight division between Government or public and private sector each combining within itself separate concepts of resourcing and a provision may get blurred and larger scope demanded for the close intermingling of the two. Further, such intermingling may involve non-Governmental organisations as well as local initiatives.

Questions of social reforms and social relevance of the globalisation and liberalisation measures are being raised in the context of reform on whether the poor will be worse off than before in absolute terms due to the reforms and whether the balance between poor and non-poor, in relative terms, will worsen as a result of reform. Given the stalemate in State action the poor may not be worse off than before and may even be able to articulate their needs better in the absence of bureaucratically determined services. There is evidence that rural prosperity has been improving significantly in the recent years. The rural-urban continuum would perhaps assert itself, but in any case, rural-urban linkages are set to get strengthened especially when the services sector is growing rapidly and replacing the traditional rural-urban divide.

Changing the Fulcrum in the Financial Sector

In India, individual sectors of the finance industry have been separately regulated and in different time perspectives. The regulatory system has evolved on a piecemeal basis with new legislation being introduced to deal with perceived problems, aided by the occasional fundamental review of the entire system. Generally, however, it has been recognised that there should be a fairly sharp distinction between banking, securities and insurance business. Even at the international level, co-ordination has tended to be within these three broad groups rather than between them.

In India, the system has apparently worked very well compared with other countries. However, as part of the finger pointing culture in which we now seem to live, any failure of a financial institution is seen to be a failure of regulation. Even on this score, India has been remarkably successful compared with, say, the United States, Japan and France. Of course, there have been failures, but there is no way of running a financial system in a competitive marketplace without an occasional failure. Not only has prudential regulation developed in different ways for the different types of institution, but in addition there has been a separate conduct of business regulation for the three sectors. Besides being subject to statutory regulation, there has been official pressure today to ensure that adequate self-regulatory mechanisms are in place.

An observer from another country looking at the system in India in the mid-1990s would have concluded that it did not work very well in theory, but that, at least comparatively speaking; it did work rather well in practice – perhaps a rather typical Indian result. But there is a limit to the extent to which theory and practice can diverge. As financial markets developed during the 1990s, so the system of regulation began to look increasingly inadequate.

The major factors justifying a comprehensive change stem from the radical change in the nature of financial markets and a compelling trend of universalisation and convergence of markets. No longer are markets dominated by specialist institutions serving specialist markets. Liberalisation of the financial markets, partly as a result of policy decisions but partly also in response to the increasing globalisation of the economy and technological developments, has broken down barriers between markets and products. There have been mergers of banks and introduction of new private insurance companies, individual banks have established insurance companies, some bank products look increasingly like insurance products, some securities look like insurance products and so on.

There is an additional factor which points towards the change in the Indian markets regulatory history. Legislation passed by the Parliament was designed to meet a very real need, which is to give greater protection to customers of investment and insurance related businesses. It provided for a regulatory regime which included within it the seeds of self regulatory organisations being overseen by the quasi bodies with statutory powers thereby ensuring prudential supervision on professional lines. This two tier system ensures that inefficiency, tensions and bureaucracy are not built in to the regulatory structure. I have no doubt that the industry played its part by similarly demanding clarity and even longer rulebooks. It is perhaps no surprise that

the first few years of the new regulatory regime everybody was too busy building the new regime to bother too much about operating it.

Ideally, the time has now become ripe for the government to give careful thought to a medium term plan for reforming the architecture of financial regulation. This process should not only take account of the past as I have just described it but, as importantly, also the future. It would also be reasonable to expect a continued rationalisation of the financial services sector.

Defining Regulation

In the present context the term 'regulation' may be taken to refer to the control of corporate and commercial activities through a system of norms and rules which may be promulgated either by governmental agencies (including legislatures and courts) or by private actors, or by a combination of the two. The direct involvement of the State is not a necessary condition for the existence of regulation in this sense, since rules may be derived from the activities of industry associations, professional bodies or similarly independent entities.

There is often a close symbiosis between private law and regulatory law although there may be some value in distinguishing between them. While this is widely used in discussion and has some merit as an analytical device, it can also give rise to difficulties if it is applied in a non reflexive way. This is because, firstly, many rules of private law, such as those relating to implied contract terms, fiduciary obligations, and duties of disclosure, have a regulatory impact in the sense of controlling transactions. Secondly, private law rules may form the basis for self-regulation in the sense that contractual associations of commercial actors may produce codes governing the conduct of their trade or profession (or, at a further extreme, impose restrictions on trade which may or may not escape the reach of competition or monopoly or restrictive trade practices law).

It also follows that the term 'deregulation' needs to be used with care. In practice, it tends to be used when referring to the removal of statutory controls. Often, however, this process gives rise to the replacement of one form of regulation by another – the common law, or self-regulation, replacing statute - rather than to a diminution in regulation. The picture is complicated further if is assumed that 'deregulation' is necessarily a process leading to the restoration of market forces which had previously been constricted by regulatory controls. Rather, it is often the case that sustainable competition rests upon regulation of a prescriptive or interventionist kind. Thus in various contexts policies or practices aimed at promoting competition have employed regulatory techniques to this end. A good example of this is provided by the operation of the securities markets.

There needs, then, to be recognition of the varieties of regulation and self regulation, and some understanding of how they operate in relation to commercial activity in particular settings. Good policy analysis is not about choosing between the free market and government regulation. Nor is it simply about deciding what the law should proscribe. It is about understanding private regulation – by industry

associations, by firms, by peers, and by individual consciences – and how it is interdependent with state regulation.

Reflexive Regulation

The aim of 'reflexive' or 'responsive' regulation is, therefore, to ensure that regulation be responsive to industry structure, and that different structures will be conducive to different degrees and forms of regulation. In some accounts, reflexive law can be used to 'steer' self-regulation: The use of regulatory intervention to induce certain desired ends through second-order effects is characteristic of "reflexive" or "procedural" regulation which aims to achieve its intended effects by encouraging self-regulation at the level of the practices and processes operated by the parties themselves.

An example of this type of regulation is 'enforced self-regulation' and which can be distinguished from 'co-regulation'. Co regulation is the process whereby associations of firms or professionals at the level of the industry concerned promulgate generalised standards for the conduct of trade. The rules in question are arrived at through a process of negotiation and deliberation within the industry. The government exercises loose supervision or oversight in the sense of intervening through competition law to curb rules which plainly have an anti-competitive effect or purpose.

Enforced self-regulation, by contrast, is a form of self-regulation in which regulatory functions are sub-contracted by the state to private commercial actors who, in this case, may be the firms themselves rather than the industry-level associations. The difference from co-regulation is that the state is ready to intervene with more stringent and less firm-specific or 'tailored' standards if private actors do not agree their own rules. The state thereby encourages a negotiated solution which is, in principle, better attuned to local conditions than would be the case with a generalised or imposed set of rules. The use of proscriptive norms and legal (including criminal) sanctions is not ruled out altogether, but, rather, is kept in reserve for situations of extreme noncompliance.

Pyramid of Regulatory Compliance

An important aspect of understanding enforced self-regulation is the 'pyramid' of regulatory compliance. Sanctions are structured in such a way as to combine persuasion in the majority of cases with direct enforcement in a smaller number. At the base of the pyramid, most actors are persuaded to comply through indirect intervention; full sanctions, such as criminal penalties or the withdrawal of a licence to operate, are reserved for the few cases at the top.

1. License Revocation
2. License Suspension
3. Criminal Penalty
4. Civil Penalty
5. Warning Letter
6. Persuasion
7. Command regulation with nondiscretionary punishment
8. Command regulation with discretionary punishment
9. Enforced self-regulation
10. Self-regulation

The purpose of the pyramid is to provide regulatees with maximum incentives for early compliance. This is an acknowledgement that, where 'persuasive' strategies are used, the regulator and the regulatee are, in effect, engaged in bargaining over the terms and timing of compliance, and that without the threat of escalating sanctions, the regulatee may have incentives to hold out in the expectation of being able to negotiate a better deal. It follows that an essential aspect of enforced self-regulation, in contrast to co-regulation, is the retention of a legal sanction (or, ideally, of a series of sanctions or interventions) which can be deployed in the last resort. Nor is it necessarily fatal to the effectiveness of the law in question that sanctions are rarely deployed.

Social Norms and Conventions

At the other extreme of the enforcement pyramid, the usefulness of a strategy of enforced self-regulation may depend on the existence of shared norms of behavior among commercial actors within a particular industry or other context. Where self enforcing norms of this kind are found, the costs of regulatory intervention can be substantially reduced in a number of ways. Where there are 'interpretive communities' of actors, the risk of opportunistic or 'creative' compliance with rules may be reduced. It also allows regulators to frame rules as generalized standards, that is to say, as open-ended norms whose interpretation and application can be left up to the parties, to whom they are addressed, hence reducing the complexity of rules. This also enables rules to evolve in response to a changing economic environment. To be inside an interpretive community means to be already and always thinking and perceiving within the norms, standards, definitions, routines of that community and to share an understanding of the goals that both define and are defined by that context. The greater the degree to which these are common amongst those writing, applying and enforcing the rules, the less it has to be rendered explicit. This has implications both for the degree to which rules have to use precision in an attempt to control and cope with a greater range of contingencies or changes which may arise. What is important is not the weight of regulation in any one system, but rather the effectiveness of the links between regulations at different levels.

This is not to suggest that the social norms and conventions of 'interpretive communities' should always be regarded as efficient or desirable. They could operate against the interests of third party groups who are excluded from the rule-making process or against what is perceived to be the public interest in a wider sense. Rather, what is being suggested is that one route by which more formal regulation can be made effective is for it to work in conjunction with social norms. Even if this is not possible, an awareness of the existence and effect of informal regulation should be an important aspect of the design of more formal rules.

Strengths and Weaknesses of Self-regulation

The value of reflexive regulation depends upon the particular commercial context in which it is applied, and, in particular, on such factors as the effectiveness of self-regulation and the presence of social norms and conventions guiding the behaviour of

commercial actors. In this vein, it may be useful to sum up the strengths and weaknesses of systems of enforced self-regulation.

(i) Strengths
Rules would be tailored to match the company. Unlike generalized rules, self-regulation can be adapted to local conditions and industry-specific factors affecting firms.
Rules would adjust more quickly to changing business environments. Rules which are specific to particular firms or industries can be changed more quickly and easily than statutory rules, and so may evolve in response to changing economic and technological conditions.

Regulatory innovation would be fostered. By allowing a variety of approaches to be adopted by firms and commercial actors, the conditions for innovative solutions (and for a degree of competition between alternative solutions) would be enhanced. Rules would be more comprehensive in their scope. Self-regulation encourages companies to deal with a wider range of hazards and abuses than legislatures can efficiently consider.

Companies would be more committed to the rules they wrote. The direct involvement of corporate actors in rule making would make it more difficult to stigmatise legal intervention as illegitimate. The confusion and cost from having two rulebooks (the company's and governments) would be reduced. Self-regulation helps to avoid duplication which might otherwise arise.
Business would bear more of the costs of its own regulation. The costs of enforcement and inspection would be internalized to those particular firms and industries which are particularly prone to creating certain hazards.

More offenders would be caught more often. There would be broader coverage by inspection under self-regulation and companies would have an incentive to engage in internal compliance and enforcement. In addition, internal procedures would be more likely to result in an efficient application of the rules and fewer opportunities for creative interpretations and appeal to the vagaries of inadequately worded legislation.
Compliance would take the path of least corporate resistance. Companies would have powerful incentives to avoid public exposure and enforcement, in part precisely because it would be rare.

Government regulation inevitably generates more costs' since there appear to be 'attenuated' incentives for cost control. Cost advantages from self regulation may come from staffing characteristics; from the speed and flexibility with which rules are administered; from reduced size of the civil service and the shifting of regulatory costs to industry. The agency problems inherent in cutting costs are arguably greater in government departments than in a situation where members of the investment community, for instance, are able to monitor a self-regulatory body.

(ii) Weaknesses
Regulatory agencies would bear the costs of approving a vastly increased number of rules. The extent to which this was a problem would depend on how far the rules in

question were subject to scrutiny and how far there was a tendency for certain model rules (in the manner of standard form contracts) to be adopted as a matter of common practice.

State monitoring would sometimes be more efficient than private monitoring. Direct government monitoring might be expected to be more efficient where companies themselves do not have the expertise to develop effective internal governance systems, or where the state has an important educational role to play.
Co-optation of the regulatory process by business would be worsened. There would be an increased risk of insider control of the regulatory process or in other words the danger of 'industrial absolutism', but this would depend on how far other affected groups were given representative status in relation to the rule making process.
Particularistic rules might weaken the moral force of laws that should be universal.

How far this becomes a problem would depend on the degree to which 'overarching standards' could be enforced, in the last resort, by public agencies. The role of general standards in informing local-level rule making would be an important issue here (as in the degree to which the legal principle of fiduciary obligation informs, in practice, the rules adopted by companies for dealing with conflicts of interests by directors).
Companies would write their rules in ways that would assist them to evade the spirit of the law. The problem of 'creative compliance' is a problem whatever form of regulation is adopted - 'the business community's resourcefulness at law evasion will be a cause for weakness in any system of control.

Companies cannot command compliance as effectively as government. This is not a problem if the State lends its powers of enforcement to the rules put in place by the corporate actors themselves. The independence of the internal compliance group could never be fully guaranteed. This is a problem which must be addressed by specific institutional devices aimed at enhancing the prestige and status of the internal inspection and compliance process. Therefore it is a function of the particular regulatory design of enforcement systems, rather than a fundamental objection to responsive regulation.

Role of a Regulator
The existing legislative enactments do not bestow adequate powers on the regulator to make rules, to interpret rules, to investigate breaches of rules, to fine people for breaches of rules, and to keep and retain the fines in all areas which they are supposed to supervise. The essence of having an independent regulator within the flexibility to rule by regulation making ensures that matters which previously could be changed only with the consent of Parliament will be capable of being changed merely by a decision of the respective financial supervisory authority. There is quite properly a very lively debate about this. On the one hand there is much to be said for a flexible system. Legislation can never foresee all eventualities and, furthermore, legislation can never be perfect. Legislation in many cases cannot also be quick enough to correct market aberrations. In many areas sensible actions have been thwarted by faulty legislation. Often industry and regulators combine to try to get round unintended effects of legislation. Surely, according to this argument, it is far preferable if the regulation is as flexible as possible allowing regulators to take

account of changing circumstances. Moreover, it is argued, one has to work with and trust the regulators and, if they cannot be trusted, then really it does not matter what sort of legislation one has.

But there is a contrary argument. No one doubts the motives, competence and qualities of the people at the top of the regulatory set up, but that can change. Moreover, sometimes major decisions can be taken some way down a regulatory body where perhaps the staff concerned does not have the broadminded approach of people at the top. If one wants to hear criticisms of any regulatory body, then people who work for other regulatory bodies and civil servants are often ready to oblige. There are a number of regulatory bodies operating today in India which are subject to criticism within government circles. Presumably the Insurance Regulatory And Development Authority, to which I belong, is not entirely immune from this danger at some time in the future.

Normally regulatory bodies are accountable by being subject to parliamentary approval for key variables, for example fees and levies, and they are also subject to a ministerial power of direction - ministers themselves being accountable to Parliament, or perhaps more nowadays to the media.

Objectives of Financial Supervision

The objectives of financial supervision are:

- maintaining public confidence in the financial system;
- promoting public understanding of the financial system, including promoting awareness of the benefits and risks associated with different kinds of investment or other financial dealing;
- securing the appropriate degree of protection for consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have in relation to different kinds of regulated activity and the general principle that consumers should take responsibility for their decisions; and
- reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime, with particular regard to the desirability of regulated persons being aware of the risk of their businesses being used in connection with the commission of financial crime and taking adequate measures to prevent, facilitate the detection, and monitor the incidence of financial crime.

In addition, in discharging its general functions the financial regulators must have regard to: the need to use its resources in the most efficient and economic way; the responsibilities of those who manage the affairs of authorised persons; the principle that a burden or restriction that is placed on a person, or on the carrying on of a regulated activity, should be proportionate to the benefit the provision is generally intended to confer; the desirability of facilitating innovation in connection with regulated activities; the international character of financial services and markets and the desirability of maintaining the competitive position in India; and the principle that

competition between authorised persons should not be impeded or distorted unnecessarily.

Recent Market Developments and Financial Supervisory Regimes

The financial services sectors of most countries have long been much influenced by market developments. These include the removal or weakening of barriers to entry and of restrictions on diversification and on various types of ownership structure; innovation and technological progress (which has had a dramatic impact on the cost of entering some markets for financial services); greater competition; and internationalisation. These developments are interrelated and mutually reinforcing. The result has been a blurring within the financial services sector of the traditional distinctions which used to apply across types of firm, types of product and types of distribution channel, albeit to different a extent and in different ways across different countries.

For financial services firms, this has been manifested as an increase in the number of institutions which cut across traditional sectoral boundaries. This growth in financial conglomerates has resulted in part from the impact of mergers and acquisitions. This also reflects the result of financial services firms extending through internal growth into new areas (for example, insurance companies setting up banks and vice-versa, insurance companies selling investment products, and banks setting up securities and fund management operations), and of new entrants to the financial services sector choosing to offer a range of financial services to their customers. In all of these cases the resulting mix of functions undertaken by the firm has been determined primarily by anticipated profits and the scope for cross-selling products to customers, rather than by any traditional linkages between, or separations across, products.

With the growth of options, increasingly elaborate ways of unbundling, repackaging and trading risks have weakened the distinction between equity, debt and loans, and even between banking and insurance business. Equally, channels of distribution are no longer as specialised as they once were. Banks have used their branches as a sales point for an increasing range of products, while many of the new entrants to parts of the financial services sector have introduced new sales methods – such as telephone and internet channels – to a wide range of products which had previously been available only through more traditional channels.

The disappearance of a neat conjunction between a particular type of firm and a limited range of products being supplied by that firm means that it is difficult to regulate on a functional basis, since the traditional functional approach no longer matches the structure of either firms or markets. The emergence of financial conglomerates has challenged traditional demarcations between regulatory agencies and the boundaries between regulators simply no longer reflect the economic reality of the industry.

There is a clear need for regulatory oversight of a financial conglomerate as a whole, since there may be risks arising within the group that are not adequately addressed by any of the specialist prudential supervisory agencies that undertake their work on a solo basis. Many of the threats to the solvency of the institution can be assessed

adequately only on a group-wide basis. This includes the assessment not only of whether the group as a whole has adequate capital, but also of the quality of its systems and controls for managing risks, and the caliber of its senior management.

Indeed, the importance of systems and controls and of senior management to the standards of compliance achieved by a firm against both the prudential and the conduct of business standards and requirements set by financial services regulators means that it is not possible to draw a clear dividing line between prudential and conduct of business regulation, since, in this respect, both types of regulation have an interest in the same aspects of a firm's business. Moreover, there needs to be an effective exchange of information and a co-ordination of regulatory requirements across the regulators responsible for different parts of a conglomerate's business, as well as mechanisms for coordinated action when problems arise in a conglomerate.

The rationale for an integrated financial services regulator reflects the benefits of clear and consistent objectives and responsibilities, and in resolving any trade offs among those within a single agency. There is a school of thought that feels the developments on the financial markets are associated with increased risks to their stability, which can best be counteracted in the future not only through improved collaboration between regulatory authorities but through integrated regulation. A convergence effect is seen wherein banks, insurance companies and securities firms are now competing in the same market for the same customers, with similar or often even identical products and via the same distribution channels, which organisationally separate regulation cannot cope, with a view to securing the future stability of the financial system.

However, this does not imply that there is any one model that is optimal for all countries in all circumstances, in part because financial markets have developed – and will continue to develop – differently in different countries. A single regulator need not necessarily deliver these advantages. Specialist divisions/areas will exist even within a single agency, thus creating potential problems in communication, information sharing, co-ordination and consistency. A single regulator in other words could potentially become an over-mighty bully, a bureaucratic leviathan divorced from the industry it regulates. Moreover, there is no single blueprint even for single financial services regulators – countries that have adopted this model developed different approaches to how their integrated regulator operates in practice. These differences include the responsibilities, powers and organizational structure of these regulators, and the legislations under which they operate.

There remain, and will remain for the foreseeable future, major differences between banks, securities firms and insurance companies in the nature of their business or the type of contracts they issue, and hence the nature and form of asset transformation. Firms in all sub sectors have diversified, but almost invariably their core business remains dominant. The nature of the risks is sufficiently different to warrant a differentiated approach to prudential regulation. The rationale for this approach (or for other possible objective-based models with more than one regulator) is attractive – giving regulators clear mandates and ensuring appropriate differentiation in the regulation of different types of activity.

But even if there is a strong case for an institution-wide overview of a financial conglomerate, is it necessary for this to be undertaken by a "lead" regulator (or "coordinator") appointed from among the "solo" regulators responsible for specialised aspects of the institution. This lead regulator would be responsible for taking a consolidated view of the capital adequacy and liquidity of the institution as a whole; taking similarly a group-wide view of more qualitative factors such as the caliber of senior management and the high-level systems and controls of the financial conglomerate; and coordinating and encouraging the exchange of information among the relevant regulatory bodies both under ordinary and abnormal circumstances. Most countries still follow the lead regulator approach.

Risk Based Supervision

Risk-based supervision is a framework that establishes common terminology and approaches to evaluating the management of risk in financial institutions. While it is a common approach, it is flexible enough to be adaptable to virtually all, if not all, financial products and services, and to institutions large and small. The disaggregation of the risks that make up the risk profiles of individual products and services is at the heart of risk-based supervision. By un-blurring the risks that make up each product and service, managers and supervisors are able to understand better risk profiles and evaluate actions taken to minimize the adverse consequences of risk-taking. It is the responsibility of the management of each financial institution to understand the risks associated with the business they are running and to take steps to minimize the adverse consequences of these risks. Risk-based supervision looks at how well management identifies, measures, controls, and monitors risks.

Risk-based supervision requires a deeper understanding of the institutions being supervised and of the environment in which they operate. It requires an understanding of the risk profile of the institution under examination in order to identify areas of the greatest risk deserving of closer attention. It requires an understanding of the nature of risks, together with management's ability to deal with both internal and external risks. Once the areas of the greatest risk have been identified, the examiner reviews the risk-management systems in those areas.

That risk-based supervision could have done a better job in reducing the adverse consequences of the Asian crisis which had its origins in three aspects of risk-based supervision:

- understanding the environment in which financial systems operate;
- understanding the risk profiles of individual institutions; and
- understanding the risk profiles of the products, services and activities that make up the individual institutions, and aggregating these individual risk profiles into a profile of the institution as a whole.

Good risk management is not an expense to be avoided or minimized; it is not even revenue-neutral; it is a revenue enhancement tool and therefore leads to capital enrichment. Good risk management allows an institution to operate with a high level of precision. Too much risk with too few controls results in loss. Too many controls and limits, given the corresponding risks, result in loss by incurring unproductive and

unnecessary expenses and by foregoing opportunities. Understanding the risk profiles of products and services, and balancing them with actions taken to reduce the adverse consequences of risk-taking, allows an institution to optimize revenues and maximize the use of capital.

Risk-based supervision enhances top-down supervision in three ways. First, it focuses supervisory resources on the areas of the highest risk within individual financial institutions. Second, it uses a common framework and common terminology, developed specifically for risk-based supervision, to assess risks and evaluate management practices, policies, and procedures in the context of managing risks; that is, optimizing returns while minimizing the adverse consequences of risk-taking. Finally, it incorporates an assessment of management's ability to deal with risks beyond the control of management, such as systemic risks and risks in the economic environment in which the financial institution operates.

Regulatory Arbitrage

It is not always the best that all of us should think alike; it is variety that makes life challenging. Regulatory choices and diversity help mitigate potential regulatory abuses. Financial supervision and regulation can only benefit from the variety of viewpoints and checks and balances of a system of more than one regulatory authority. A system in which financial institutions have choices, and in which regulations result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of supervision. A single regulator is likely to have a tendency to suppress risk taking. A system of multiple supervisors and regulators creates checks on this propensity.

The financial services industry today is extremely complex. Regulators, whether rule makers or supervisors cannot be expected to meet the challenge of understanding the issues facing the industry without direct and frequent contact with the regulated institutions.

The current regulatory system does however create some opportunity for "regulatory arbitrage". Within the context of our current regulatory scheme, however, regulatory arbitrage can be good particularly during cycles of over-zealous regulation when regulators focus on actual or perceived negative outcomes. Regulatory arbitrage can put some practical limits on the power of any one regulator.

Separating the rule making and supervisory functions would create the very high risk of an "ivory tower" of rule making, detached from the realities of the financial services industry. Most financial institutions would agree that a supervisory agency is positioned the best to write regulations for the financial institutions that it supervises, and can readily gauge the impact that any regulation will have on those entities.

Regulatory arbitrage will occur whether you have one supervisory or rule making authority or multiple authorities. With only a single rule making or supervisory agency, regulatory arbitrage can go unchecked and have disastrous consequences.

Conflict resolution

It must also be recognised that in practice governments have been slow and ineffective in resolving conflicts of interest between different objectives and

responsibilities between multiple specialist regulators. These problems arise because they either do not have clear objectives and responsibilities or because the institutions were set at different times and are inconsistent with each other. Thus even if all specialist regulators are focused effectively on delivering their own specific mandates, the sum of the parts need to add up to a coherent and consistent overall outcome. Governments may lack the necessary information and experience to take decisions here, and may also be reluctant to do so if it brings them too close to the regulation of individual financial institutions.

Appropriated differentiation

Multiple regulators however ought to be able to avoid the unjustifiable differences in supervisory approaches and the competitive inequalities imposed on regulated firms through inconsistent rules. However, this does not mean the adoption of a "one size fits all" approach. What is required is harmonisation, consolidation and rationalization of the various principles, rules and guidance in the regulatory material issued by the specialist regulators – so that similar risks are treated similarly irrespective of where they arise – and the need to create and to preserve appropriate differentiation to reflect the different degrees of protection required by different types of consumers.

Institutional Structure for Financial Services Regulation in India

The institutional structure of financial services regulation is important because of the impact of the efficiency and effectiveness of this on the direct and indirect costs of regulation and on the success of regulation in meeting its statutory objectives. To what extent should the structure of financial regulation be driven by the functions which financial services firms undertake, reflecting market developments in the financial services industry? Is there a first-best institutional arrangement which is independent of these market developments, arising perhaps from economies of scale and scope in undertaking financial regulation, or from some underlying logical of the structure of regulation with the objectives of regulation or with the institutional arrangements for monetary policy and for addressing systemic risk? Are there also implications here for the structure of regulation internationally, not just within national borders?

The existing arrangements for financial regulation involve a large number of regulators, each responsible for different parts of the industry. In recent years as has been seen earlier there is a blurring of the distinction between different kinds of financial services business.

We now turn to a more specific examination of particular areas of regulation in India, beginning with the regulation of financial services. The main regulatory functions are carried out by non-governmental bodies. These responsibilities are largely conferred by different Acts. Financial services have been regulated based on tripod based regulatory structure, comprising of the Reserve Bank Of India, Securities Exchange Board of India and Insurance Regulatory And Development Authority. A High level Capital Markets Committee presently co-ordinates and monitors the financial regulatory system.

The second tier consists of a number of organisations belonging to various categories of statutorily recognised bodies. These include Self-Regulating Organisations, Recognised Professional Bodies, Recognised Investment Exchanges and Recognised

Clearing Houses. Together they perform front-line authorisation of financial services businesses and markets.

The Ministry of Finance is responsible for the overall institutional structure of regulation and for the legislation which governs it; for the overall stability of the financial system, for the financial system infrastructure, for the efficiency and effectiveness of the financial sector and, under specified conditions, to undertake financial support operations.

The financial regulators are responsible for the authorisation and supervision of financial services firms, for the supervision of financial markets and of clearing and settlements systems, and for regulatory policy in all these areas.
Corporate Governance

An area where self-regulation should dominate is that of corporate governance regulation. A number of corporate governance codes have followed in fairly rapid succession to address perceived corporate governance weaknesses. Neither the sponsors nor the participants in the process of drafting these codes were government institutions and their enforcement is dependent on shareholder pressure through the Stock Exchange.

Accountability
The existing statutes contain a range of accountability provisions. These include that the Chairman and Board/ Members of the regulatory bodies would be appointed and removed by Government; that in exercising its rule-making powers and setting its policies the Government should act in a way which is compatible with the regulatory objectives set out in the legislation and which is most appropriate for meeting those objectives; that the Government should make an annual report to Parliament upon the discharge of the functions of the regulators and the extent to which regulatory objectives have been met; that the Government is likely to be asked to give periodic evidence to the Parliament; that an advisory committee comprising of non-executive members of the Board are involved through a series of consultations to develop its regulatory approach further besides ensuring that the regulatory institutions function in an economic and efficient way; the Comptroller and Auditor General reviews on the adequacy of internal financial controls and reports on these matters in his annual report; besides ensuring that they maintain a consistent – but not necessarily identical – approach in discharge of their functions.

A further important aspect of accountability is that there must be a clear allocation of responsibilities between the Government and the financial regulators. A memorandum of understanding between the financial regulator and the Government which sets out the responsibilities of the Government for the overall institutional structure of regulation, and for the legislation which governs it; and for the overall stability of the financial system, including the stability of the monetary system, for the financial system infrastructure, for being able in exceptional circumstances and subject to the agreement of the Government to undertake official financial support operations for the efficiency and effectiveness of the financial sector; and of the financial services regulators for the authorisation and supervision of financial services firms, for the

supervision of financial markets and of clearing and settlement systems, for the conduct of market-based support operations which do not involve official finance in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, and for regulatory policy on all of these.

The Regulatory Pitfalls

At one time, regulation was believed to be the cure-all for various forms of "market failure" inherent in many industries, such as natural monopolies, externalities and information asymmetries. However, years of regulatory experience in many developed countries reveal that regulations, like markets, can also "fail." Let us review what constitutes a "regulatory failure," which was the root cause of waves of deregulation world-wide.

Regulatory failure may occur for two reasons. The first is associated with the "capture theory." The theory posits that because the regulated companies are likely to have superior information, they can easily manipulate the regulator to their own advantage. Alternatively, these firms can easily form themselves into a formidable lobbying group that may influence government policies. The second reason for a regulatory failure arises from the fact that the regulator itself is not perfect. We must not forget that by creating a regulator, we entrust an enormous amount of responsibility and power unto a single body. This resembles an autocratic government. We all hope for a benevolent and an efficient regulator, but there are both up-side and down-side risks involved when power is concentrated in a single entity.

One other feature often noticed in the unfolding regimes in the recently liberated economies is the total lack of perception in government circles on the concept and principles of regulation namely a reluctance on the part of bureaucracy that controlled the sector erstwhile in its mindset of regulation being equivalent to ownership. The apparent loosening of their hold on the units publicly owned and controlled by it to a proper no nonsensical regulation greatly affects its thinking and action. It is also observed that the public sector companies, hitherto sheltered and cosseted by government, tend to look at regulations as inconveniences and threats to their inertia.
What can be done? At the initial stage where markets become more open to competition and state enterprises are replaced by private operators, the regulatory burden will become overwhelming. The prospect of strengthening the regulatory authorities within the bureaucratic setting is bleak. Low pay-scale, political meddling and red tape are guarantees that the current inefficiencies will prevail. The establishment of an independent regulatory body can lessen the severity of the mentioned problems. And to ensure its effectiveness and impartiality, let transparency be the soul of its design.

The Case for Independence

Establishing adequate independence arrangements is crucial to reducing the likelihood of political interference in the supervisory process. The debate on regulatory independence is at the same stage the debate on central bank independence was two decades ago.

Nonetheless, independence for financial regulatory agencies matters for financial stability for many of the same reasons that central bank independence matters. An independent regulator can ensure that the rules of the regulatory game are applied consistently and objectively over time. If bankers know in advance that insolvent banks will be closed—and that lobbying to keep them open will fail—they will behave more prudently, thereby reducing the likelihood of a full-blown banking crisis. In contrast, when politicians become directly involved in enforcing regulations, they may be influenced by other considerations in making their decisions, which then take on an ad hoc quality. The crises that erupted during the 1990s in a number of countries where regulatory and supervisory agencies were not independent strongly support the case for independence. Examples of crises averted because of better regulatory governance would also support the case for independence, but, given the confidential nature of supervision, these are not likely to be revealed.

Perils of Lack of Independence – Lessons from International Experience

Before the Asian crisis began in 1997, Korea's specialized banks and non-bank financial institutions were under the authority of the ministry of finance. The ministry's supervision of non-banks was generally recognized as weak, encouraging regulatory arbitrage and excessive risk taking. As in many other Asian crisis countries, politically motivated forbearance was widespread. The most glaring examples of political interference in financial sector supervision were the government's decisions to intervene in certain banks or to provide them with government funds for recapitalization.

In Japan, the lack of independence of the financial supervision function within the Ministry of Finance is also widely believed to have contributed to financial sector weaknesses. Although there was probably little direct political pressure on the Ministry of Finance to exercise forbearance, the system lacked transparency and was known for widespread implicit government guarantees of banking sector liabilities. Following a decline in the ministry's reputation as a supervisor in the late 1990s, the Japanese government created a new, integrated Financial Supervisory Agency, which was more independent and transparent than its predecessor was. However, the agency, which reports to the prime minister's office rather than to the finance ministry, has achieved disappointing results to date.

Ineffective regulation, weak and dispersed supervision, and political interference in Venezuela were among the main factors in the weakening of banks in the run-up to the 1994 banking crisis. One of the main lessons of this crisis was that there was a need for more independence for financial sector regulators and supervisors and political support for their work.

Global initiatives for Effective Financial Sector Regulation

Political interference in financial sector regulation and supervision contributed to the depth and magnitude of nearly all of the financial crises of the past decade. As a result, the global community—increasingly aware of the need for good regulatory governance as part of a broader effort to prevent (or better manage) financial crises and improve financial sector supervision—has started to look for ways to insulate regulators and supervisors from improper influence. In recent years, the international

community, including the International Monetary Fund (IMF) and the World Bank, has launched a number of initiatives to promote and monitor good governance—meaning the way institutions are run, supervised, and held accountable. We are at a point now where we can begin to draw some lessons and rethink our approaches to policymaking. We can also say with greater certainty that the independence of regulatory and supervisory agencies is a cornerstone of good regulatory governance, a topic that has received little attention.

A financial system is only as strong as its governing practices, the financial soundness of its institutions, and the efficiency of its market infrastructure. Instilling and applying sound governance practices are a responsibility shared by market participants and supervisors. Market participants must establish good governance practices to gain the confidence of their clients and the markets. Regulatory agencies play a key role in instilling, and overseeing the implementation of, good governance practices. And regulatory agencies need to follow sound governance practices in their own operations or they will lose the credibility and moral authority they need to be effective in their oversight role—opening the door to moral hazard, unsound market practices, and, ultimately, financial crises.

Further evidence of the desirability of independence comes from the Financial Sector Assessment Program (FSAP) launched in May 1999 by the IMF and the World Bank. The FSAP enables the two institutions to assess the extent to which countries' current regulatory governance arrangements and regulatory independence (or lack thereof) is contributing to vulnerabilities in financial systems. The benchmarks against which a country's current practices are assessed are the IMF Code of Good Practices on Transparency in Monetary and Financial Policies, the Basel Core Principles for Effective Banking Supervision, the Committee for Payment and Settlement Systems' Core Principles for Systemically Important Payment Systems, the International Organization of Securities Commissions' Objectives and Principles of Securities Regulation, and the International Association of Insurance Supervisors' Insurance

Core Principles.
Thus far, about 50 countries have participated in the FSAP, and assessments have revealed numerous shortcomings. Many supervisory agencies struggle with political influence in the form of interference in the decision-making process, arbitrary removal of senior management, or lack of budgetary independence. Improper influence by the entities they are supposed to supervise is also a big problem. Legal action—or the threat of such action—against supervisors who do not have legal protection in the execution of their job, and supervisors' often inadequate enforcement powers have not only impeded their ability to apply supervisory measures consistently but also undermined the credibility of banking supervision itself. Further undermining supervisory effectiveness is the lack of trained supervisors and uncompetitive salaries. Assessments have revealed that independence and accountability arrangements in the supervision of securities markets and the insurance sector are even weaker than those for banking.

Making Independence Work
To be effective, regulatory agencies must enjoy independence in four areas:

Regulatory independence — means that agencies should have an appropriate degree of autonomy in setting prudential regulations, within the broader legal framework. Supervisors who can define regulations are in a better position to respond quickly and flexibly to changing needs and trends in the international markets. Supervisors will also be more motivated to implement and enforce regulations if they have been closely involved in the rule-making process.
Although supervisors have the autonomy to issue prudential regulations in a large number of countries, they lack such powers while in some other countries, the regulatory powers of government and supervisors are not clearly delineated. Encouraging news is that in several countries where supervisory arrangements have been revised recently, regulatory autonomy has been strengthened.
Supervisory independence — is critical to enforcing rules, imposing sanctions, and managing crises. To be effective, supervision must be largely invisible, but this very invisibility makes supervision vulnerable to interference from both politicians and supervised entities. To protect their integrity, supervisors should enjoy legal protection when carrying out their responsibilities so that they cannot be sued personally for their actions—which can paralyze the supervisory process. Appropriate salaries should help agencies attract and retain competent staff and discourage bribe taking. Introducing rules-based systems for sanctions and interventions could also discourage improper interference.

Supervisors should be given the sole authority to grant and revoke licenses—with proper appeals procedures in place for those where licenses have been refused or revoked—because they have the best view on the composition of supervised sectors.
Moreover, if power were to be in the hands of another government agency or ministry, threats to revoke the licenses lack teeth. Practices with respect to licensing and withdrawing licenses differ greatly around the world, ranging from the government having sole responsibility (Malaysia), to consultation arrangements (Austria, the Czech Republic, Hungary), to total autonomy for the supervisors (Australia, Belgium, Italy, United Kingdom and India). Typically, governments tend to be more involved in withdrawing than in granting licenses.

Institutional independence — is guaranteed by clear arrangements for appointing and dismissing senior personnel, the agency's governance structure, the roles and responsibilities of board members, and transparency in decision making.
Budgetary independence — is needed so that the agency has the freedom to determine its staffing, training, and remuneration needs. Budgetary autonomy is generally better established in countries where supervisors are part of the central bank, because of the latter's budgetary autonomy, and in countries that recently established an integrated (unified) supervisory agency. Many countries are increasingly using an industry levy to fund regulation, and this can reinforce autonomy by freeing regulators from the government's direct budgetary control.

To be sure, independence for regulatory agencies does not mean the complete absence of political control. One legitimate concern is that independent agencies will turn into "an uncontrolled fourth branch of government." This concern is especially acute for financial sector supervisors, because they possess powers unmatched by most other regulatory agencies. When intervening in the operations of financial institutions or

revoking licenses, these agencies exert the coercive power of the state against private citizens. Therefore, accountability, transparency, and integrity are crucial in preventing the abuse of such far-reaching powers. Because they need to justify their actions in terms of their mandate, independent agencies must be accountable not only to those who delegated their responsibilities to them—the executive or legislative branches of government—but also to the public at large. They must also make public—in a comprehensive, accessible, and timely manner—data and other information, particularly about objectives, frameworks, decisions and their rationale, and terms of accountability. Finally, the integrity of agency staff is critical in ensuring that they pursue institutional goals without compromising the goals in their own behavior or self-interest.

Some aspects of financial sector supervision—including the need for confidentiality and the difficulty of measuring the extent to which supervisors are achieving their objectives—make it difficult to ensure accountability. A legal basis for supervisors' actions needs to be established, along with clear objectives; well-defined relationships with the executive, legislative, and judicial branches of government; procedures for appointment and dismissal of chief executives; override mechanisms; budgetary accountability rules; and rules supporting transparency.

Despite the importance of regulatory independence as a component of good regulatory governance, current practice in many countries falls short of the ideal. Much work remains to be done to strengthen the independence of regulatory agencies around the world and, by the same token, improve the quality of regulatory governance.

In the interest of financial stability, as much attention should be given to ensuring the independence of the supervisory agencies as has been given to ensuring central bank independence. Effective independence cannot be achieved without support from the broader political environment, however. Vested political interests in the financial system remain strong in many parts of the world, and the cost of overriding regulators is often low and one of the reasons is institutional intolerance of them in this country. Nevertheless, the need to pursue the goal of independent and accountable regulators and supervisors in the interest of long-term financial stability is as great as ever. Politicians must be convinced of this view.

Possible Impact of Recent Policy Changes

Pensions and insurance remain different in the eyes of the Government even if they are increasingly convergent, and it is important to ensure that the interests of insurance companies receive adequate weight in the post budget deliberations of the Government.

The early announcements from the government acknowledge that there would be two bites at the insurance cherry. The first one would transfer insurance supervision to the Insurance Regulatory and Development Authority. This legislation has duly been passed and implemented. The second piece of legislation would complete the reorganization of the Pensions regime with the formation of a new Pensions Regulatory and Development Authority. The new system is ambiguous which it

should be. It also opens the scope for a struggle for power between two regulatory bodies - IRDA and the proposed PRDA. There could be overlap of functions between the two – especially in the legal background that annuities could be offered in India only by life insurance companies. Prudence demands that regulatory arbitrage and administrative and regulatory costs and mechanism should be avoided and that would be possible only when a single supervisor for the insurance and pension regime is retained.

It is contrary to the widely held world view integrating the organisations as much as possible in advance of the legislation being implemented. It is apparent that the government's original intention of completing the legislation on pension's regulations is simply not achievable as there is no realistic chance of any bill being introduced in Parliament before the Monsoon 2003, in which case it could not complete its passage through Parliament by the end of the year thereby further delaying reforms in an important area.

The new policy announcement does not address convincingly the risk that pensions business would be subject in the context of multiple functional regulators, in particular because many firms would be subject to regulation by more than one of the regulator (and some by all of them). And the inefficiencies and complications inherent in a multiple regulator structure can only increase as financial conglomerates become more prevalent, thus potentially outweighing the advantages of an objectives-based structure.

Preparing for the Future

Our objectives today are to obtain long-term stability through stability in policy making and stability in the economy. In the modern economy, demand for more openness and transparency than in the past. Openness builds confidence in the Government's ability and determination to maintain economic stability. And we set out clear choices for the country. There is the opportunity now for sustainable growth - growth that will create job opportunities and generate the wealth this country needs.

Ahead of the worldwide reform of the international financial system, and in the wake of the Asian crisis, emerging economies independently introduced various domestic controls and regulations. It is understandable that they resorted to such countermeasures; however, it is an undesirable solution for the long term. A shift from the individual nation approach to a coordinated regional strategy may be a practical alternative for emerging economies.

And the financial services regulators have demonstrated that they are prepared for the future, keeping a close eye on international trends and pressing on with an agenda, which will bring more sweeping reform. On these foundations, they are determined to increase India's share of the financial services pie.

We must never forget that markets are built by the sweat and toil of human hands. The success of financial markets and of the financial services sector is the combined result of the successes of we Indians, each working to build a better life for the

families, for the potential rewards of today's marketplace are no different than they were in our parents' generation, nor even our grandparents'.

Appropriate policies and regulations that incorporate the rural and social sectors of the population system must be to permit the provision of financial services that respond to what the poor want. Financial systems that work for the poor majority should: encourage a range of institutions and methodologies; promote rigorous performance standards; and provide appropriate support modalities to help the sector grow. Pillars of sustainable financial services to the poor are: transparency and performance standards for all institutions in micro-finance; financial regulation that fits the needs of micro-finance portfolios; legal structures that work for regulated and institutional infrastructure (finance, capacity building, standards). There are key, distinct roles for practitioners and networks, policy makers and regulators and external actors to play in ensuring sustainable, responsive financial services to the poor.

In the end, our financial markets and our financial institutions provide an opportunity-but only if we have faith in them, in our country, and in ourselves. And I can assure you the regulators in this arena will do their utmost to help strengthen this trust and create an unparalleled competitive advantage-an Indian advantage.

That is, after all, the best way forward.

THE END OF DEVELOPMENT FINANCE
C P Chandrasekhar, February 22, 2004

FINANCIAL liberalization is leading to the death of development banking in the country. Close to two years back, on March 30, 2002, the Industrial Credit and Investment Corporation of India (ICICI) was through a reverse merger integrated with ICICI Bank. This was the result of a decision (announced on October 25, 2001) by ICICI to transform itself into a "universal bank" that would engage itself not only in traditional banking but investment banking and other financial activities. The proposal also involved merging ICICI Personal Financial Services Ltd and ICICI Capital Services Ltd with the bank, resulting in the creation of a financial behemoth with assets of more than Rs 95,000 crore. The new company was to become the first entity in India to serve as a financial supermarket and offer almost every financial product under one roof.

DESTROYING DEVELOPMENT BANKS
Since then similar moves have been underway to transform the other two principal development finance institutions in the country, the Industrial Finance Corporation of India (IFCI), established in 1948, and the Industrial Development Bank of India (IDBI), created in 1964. In early February, finance minister Jaswant Singh, announced the government's decision to merge the IFCI with a big public sector bank, like the Punjab National Bank. Following that decision, the IFCI board has approved the proposal, rendering itself defunct.

More recently the Parliament has, after debating the matter for more than a year, approved the corporatisation of the IDBI and paved the way for its merger with a bank as well. When the bill was put through with some difficulty in the Rajya Sabha, it appeared that the government had provided two commitments. The first was that the it would retain a majority stake in the entity into which the IDBI would be transformed. The government currently has a 58.47 per cent stake in IDBI. And, second that the development finance emphasis of the institution would be retained. But already doubts are being expressed about the government's willingness to stick to the first of these commitments. And once the merger creates a universal bank as a new entity, with multiple interests and a strong emphasis on commercial profits, it is unclear how the second commitment can be met either.

These developments on the development-banking front do herald a new era. An important financial intervention adopted by almost all late-industrialising developing countries, besides pre-emption of bank credit for specific purposes, was the creation of special development banks with the mandate to provide adequate, even subsidised, credit to selected industrial establishments and the agricultural sector. According to an OECD estimate quoted by Eshag, there were about 340 such banks operating in some 80 developing countries in the mid-1960s. Over half these banks were state-owned and funded by the exchequer; the remainder had a mixed ownership or was private. Mixed and private banks were given government subsidies to enable them to earn a normal rate of profit.

REASONS FOR THEIR CREATION

The principal motivation for the creation of such financial institutions was to make up for the failure of private financial agents to provide certain kinds of credit to certain kinds of clients. Private institutions may fail to do so because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned.

In practice, financial intermediaries seek to tailor the demands for credit from them with their funds by adjusting not just interest rates, but also the terms on which credit is provided. Lending gets linked to collateral, and the nature and quality of that collateral is adjusted according to the nature of the borrower and supply and demand conditions in the credit market. In the event, depending on the quantum and costs of funds available to the financial intermediary, the market tends to ration out borrowers to differing extents. In such circumstances, borrowers rationed out because they are considered risky may not be the ones that are the least important from a social point of view.

These problems can be aggravated because certain kinds of insurance markets for dealing with risk are absent and because in some (especially, developing-country) contexts certain kinds of long-term contracts may not just exist. They need to be created by the state, and till such time state-backed lending would be needed to fill the gap.

Industrial development banks also help deal with the fact that local industrialists may not have adequate capital to invest in capacity of the requisite scale in more capital-intensive industries characterised by significant economies of scale. They help promote such ventures through their lending and investment practices and often provide technical assistance to their clients. Some development banks are expected to focus on the small-scale industrial sector, providing them with long-term finance and working capital at subsidised interest rates and longer grace periods, as well as offering training and technical assistance in areas like marketing.

Fundamentally of course, development banking is required because social returns exceed private returns. This problem arises because private lenders are concerned only with the return they receive. On the other hand, the total return to a project includes the additional surplus (or profit) accruing to the entrepreneur. The projects that offer the best return to the lender may not be those with the highest total expected return. As a result good projects get rationed out necessitating measures such as development banking or directed credit.

IMPACT OF LIBERALISATION

There is another way in which the gradual dissolution of the core of India's development banking infrastructure is related to the process of liberalisation. This was the effects of liberalisation on the profitability of an institution like the IFCI, for example. According to the D Basu Expert Committee, which was appointed by IFCI's governing board to examine the causes of the large NPAs accumulated by the institution and suggest a restructuring, immediately following its corporatisation and initial public offering in 1993, IFCI embarked upon a programme of rapid expansion of business. To scale up the volume of business it increasingly raised resources from the debt markets. This was at a time when interest rates were relatively high. In order to cover the high cost borrowings, the institution was forced to make investments in what were considered high yielding loan assets.

Unfortunately, this occurred at a time when financial liberalisation had put an end to the traditional consortium mode of lending, in which all major financial institutions collaborated in lending to a single borrower as per a mutually agreed pattern of sharing. Liberalisation was introducing an element of competition among financial institutions. In the event, in search of high returns IFCI chose to take relatively large exposures in several green-field projects (notably in the steel and oil sectors).

For a number of reasons these projects did not deliver on their promise. Many of these projects had expected to raise substantial equity from the capital market as well as from the internal resources of group companies. Depressed conditions in the capital market put paid to the first. Recessionary conditions limited the second. Many of these groups were in the traditional commodity sectors such as iron and steel, textiles, synthetic fibres, cement, sugar, basic chemicals, synthetic resins, plastics, etc. Besides the general recessionary environment, some of these sectors were particularly affected by the abolition of import controls and the gradual reduction of tariffs. Internal resource generation, therefore, fell short of expectations. As a result, with inadequate

own-financing, in the pipeline many of these projects suffered from cost- and time-overruns.

Unlike other financial institutions, IFCI had not diversified into other types of businesses. Project finance still accounted for 94 per cent of IFCI's business assets. As a result, the impact of NPAs arising from the factors cited above was the greater in the case of IFCI than in the case of other institutions. In addition, there was sharp rise in IFCI's gross NPA level in 1998-99 (Rs 5,783.56 crore as against Rs 4,159.84 crore in the previous year) as a result of the implementation of the mandatory Reserve Bank of India guidelines for classifying non-performing assets. As a result, certain loans, particularly those relating to projects under implementation, which had been treated as performing assets in earlier years, had to be classified as non-performing.

The Basu Committee had noted that some of the factors referred to above such as impact of trade policy liberalisation and tariff reduction, recessionary conditions in the late 1990s, depressed conditions in the capital market, etc, affected other DFIs and banks as well. However, the impact was particularly pronounced in the case of IFCI, as the concentration of risk relative to net worth was much higher. Also, as already stated, other DFIs had started diversifying into non-project related lending and business. It was difficult to survive as a development finance institution in the new environment.

Thus the decline of development finance is clearly related to the process of economic liberalisation. However, as a number of industry associations have noted in recent times, it hardly is true that in a time of growing competition for Indian firms from international business and a growing liberalisation-induced shift in the investment and lending practices of banks and NBFCs away from manufacturing, state support for domestic private investment is not relevant. But given the ethos of liberalisation this does not seem to matter.

INDIAN FINANCIAL SECTOR AFTER A DECADE OF REFORMS

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1. Introduction

The economic reform process that began in 1991 took place amidst two acute crises involving the financial sector:

- the balance of payments crisis that threatened the international credibility of the country and pushed it to the brink of default; and
- The grave threat of insolvency confronting the banking system which had for years concealed its problems with the help of defective accounting policies.

Moreover, many of the chronic and deeper-rooted problems of the Indian Economies in the early nineties were also strongly related to the financial Sector:

- the problem of financial repression in the sense of McKinnon-Shaw (McKinnon, 1973; Shaw, 1973) induced by administered interest rates pegged at unrealistically low levels;
- large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit;

- excessive structural and micro regulation that inhibited financial innovation and increased transaction costs;
- relatively inadequate level of prudential regulation in the financial sector;
- poorly developed debt and money markets; and
- outdated (often primitive) technological and institutional structures that made the capital markets and the rest of the financial system highly inefficient.

Financial sector reforms have therefore been an important part of the overall reform process. Yet, after a decade of reforms, many of the deep seated problems in the financial sector remain. The hopes that were raised by the impressive progress in the initial years of the reforms have not been fulfilled. The state has not relinquished its grip on the financial sector. Except in isolated pockets, competition has not been unleashed in the financial sector on a scale sufficient to produce visible benefits in terms of efficiency, innovation and customer service.

This paper begins with a critical review of financial sector reforms in some key areas. It then goes on to assess the impact that these reforms have had on the corporate sector and on retail investors. Finally, the paper outlines the unfinished agenda of reforms in the financial sector.

Exchange Control and Convertibility

Early Success One of the early successes of the reforms was the speed with which exceptional financing was mobilized from multilateral and bilateral sources to avert what at one stage looked like a imminent default on the country's external obligations. Subsequently, devaluation, trade reforms and the opening up of the economy to capital inflows helped to strengthen the balance of payments position. Substantial reserves were built up out of non-debt-creating capital inflows. The significant reforms in the area of exchange control were:

- Exchange controls on current account transactions were progressively relaxed culminating in current account convertibility.
- Foreign Institutional Investors were allowed to invest in Indian equities subject to restrictions on maximum holdings in individual companies. Initially, there were severe restrictions on foreign investment in debt securities, but these were progressively relaxed.
- Indian companies were allowed to raise equity in international markets subject to various restrictions.
- Indian companies were allowed to borrow in international markets subject to a minimum maturity, a ceiling on the maximum interest rate, and annual caps on aggregate external commercial borrowings by all entities put together.
- Indian mutual funds were allowed to invest a small portion of their assets abroad.
- Indian companies were given access to long dated forward contracts and to cross currency options.

Subsequent Back Sliding

A substantial part of the reserve build-up has been out of non-debt-creating capital inflows. In later years, however, the government has resorted to borrowing (through the State Bank of India) in the form of the Resurgent India Bonds in 1998-99 and the India Millennium Deposits in 2000-01. These borrowings have been part of a conscious strategy of maintaining a strong exchange rate rather than seeking competitive parity with East Asian competitors and China.

Half way through the reform process, there were serious discussions on moving towards capital account convertibility. A report by the Tarapore Committee (RBI, 1997) prepared a detailed roadmap for such a move. At around this time, however, the Asian Crisis engulfed East and South East Asia. Policy makers in India were quick to conclude that there were major advantages in retaining tight controls on the capital account. However, this status quo posture carries grave risks because:

- The Indian economy is already substantially open to capital inflows, and the existing restrictions are predominantly on capital outflows.
- The capital account is significantly more open to the corporate sector than to individuals.
- India's unwillingness to match the sharp currency depreciation of its East Asian competitors makes it quite possible that the Indian Rupee has been overvalued from the point of view of export competitiveness. All these features were contributory factors in the East Asia, and it is possible that maintenance of the status quo would create serious vulnerabilities in the long run for India as well. In this context, it is heartening that the budget speech for 2002-03 has put capital account convertibility on the agenda once again though no significant steps have been taken in this direction.

Banking and credit policy

Banking System Solvency

At the beginning of the reform process, the banking system probably had a negative net worth when all financial assets and liabilities were restated at fair market values (Varma 1992). This unhappy state of affairs had been brought about partly by imprudent lending and partly by adverse interest rate movements. At the peak of this crisis, the balance sheets of the banks, however, painted a very different rosy picture. Accounting policies not only allowed the banks to avoid making provisions for bad loans, but also permitted them to recognize as income the overdue interest on these loans. The severity of the problem was thus hidden from the general public.

The first decade of reforms therefore included the following banking reforms:

- Capital base of the banks was strengthened by recapitalization, public equity issues and subordinated debt.
- Prudential norms were introduced and progressively tightened for income recognition, classification of assets, provisioning of bad debts, marking to market of investments.
- Pre-emption of bank resources by the government was reduced sharply.
- New private sector banks were licensed and branch licensing restrictions were relaxed. The threat of imminent insolvency that loomed large in the early 1990s was, by and large, corrected by the government extending financial support of over Rs 200 billion to the public sector banks. The banks also used

a large part of their operating profits to make provisions for non performing assets (NPAs). Capital adequacy was further shored up by revaluation of real estate and by raising money from the capital markets in the form of equity and subordinated debt. In the last couple of years, some public sector banks have also moved aggressively to cut costs by trimming the workforce and by divesting peripheral business units that have not been doing well.

It is noteworthy that the direct government support to the banking system was only about 2% of GDP. By comparison, governments in developed countries like the United States have expended around 5% of GDP to pull their banking systems out of crisis and governments in developing countries like Argentina and Chile have expended more than 15% of GDP (Sunderarajan and Balino, 1991, International Monetary Fund, 1993 and International Monetary Fund, 1998). There was however a large indirect support to the banking system in terms of a favourable regulatory regime that restricted competition within the banking system and smothered competition from outside the banking system

The net effect of the government support and internal restructuring undertaken by the banks themselves was that with the exception of two or three weak banks, the public sector banks appeared to have put the threat of imminent insolvency behind them. In recent years, however, the banking system has had to contend with the debilitating effects of an ongoing recession in the manufacturing sector. This has led to significant non performing assets, and if the economic outlook continues to weaken, the financial health of the banking system could deteriorate sharply.

It is also pertinent to note that independent estimates of the percentage of bank loans that could be problematic are far higher than the reported figures on non performing assets, even though the accounting and provisioning norms have moved closer to international norms. During the Asian crisis, the international rating agency S&P published a report estimating potential (worst case) problem loans in the Indian banking sector at 35-60% of total bank credit (Standard and Poor, 1997). Subsequently, S&P has continued to re-affirm this estimate (most recently in Standard and Poor, 2001). By its very nature, the scenarios that underlie S&P's worst case analysis involve assumptions that are severe and unlikely to materialise. Nevertheless, the fact that S&P continues to place India in the weakest category of banking systems (alongside countries like China, Pakistan, Mexico, Thailand and the former CIS countries) is an indication of the potential weaknesses in the banking system. It would thus appear that while the imminent threat of insolvency that existed at the beginning of the reforms has receded, the threat remains latent.

Governance and Lending Practices

An even more important question is whether the banks' lending practices have improved sufficiently to ensure that fresh lending (in the deregulated era) does not generate excessive non performing assets (NPAs). That should be the true test of the success of the banking reforms. There are really two questions here. The first question is whether the banks have achieved sufficient managerial autonomy to resist the kind of political pressure that led to excessive NPAs in the past through lending to borrowers known to be poor credit risks. A decade after reforms, it is evident that this

has not happened. It is true that in the initial years of the reforms, the political system appeared to have exercised greater restraint in its use of the banking system as a tool for patronage. But this has not been institutionalised in a culture of managerial autonomy, and there is no assurance that the political self restraint will endure. The second question is whether the banks' ability to appraise credit risk and take prompt corrective action in the case of problem accounts has improved sufficiently. It is difficult to give an affirmative answer to this question.

The managerial response to the threat of non performing assets has been a flight to quality rather than an attempt to improve their credit assessment skills and systems. The RBI's annual report for 2001 points out that "As at end-March 2001, commercial banks held SLR1 securities amounting to 35.1 per cent of their net demand and time liabilities as compared with the statutory SLR requirement of 25.0 per cent. Banks' holding of SLR paper, amounting to about Rs.1, 06,000 crore over and above the SLR requirement, was substantially higher than the net annual borrowings of the Central Government."

Some of the reticence to lend is attributable to the increased fear of the anti-corruption wing of the government. There has been a tendency on the part of this wing to regard every non performing loan as a potential case of corruption on the part of the lending officer. Even if the officer is acquitted at the end of the investigations, the investigation procedures are such that the officer would in the meantime have undergone significant mental agony and might also have lost out on several opportunities. The result is a strong disincentive to take lending decisions.

Paradoxically, the result of the anti-corruption measures may actually be to increase corruption and worsen the lending portfolio. This is because the honest officers become reluctant to lend as they get few rewards for right decisions and face inquiries for wrong decisions. For the truly corrupt officer, the bribe is probably large enough to compensate for any disciplinary action that may take place. The corrupt officer would also probably have enough friends and money to mount a strong defence and thereby ensure a high probability of an acquittal or a mild punishment. It is self evident that when honest officers stop lending and corrupt officers continue to lend, more loans are likely to go bad and the level of non performing assets are likely to increase.

There has been an unwillingness on the part of the government to recognise that an anti corruption drive can be successful only if it is based on the highest standards of natural justice and provides full protection to honest officers. An investigative system in which people are treated as innocent until proved otherwise is the only sensible one however difficult it may make the investigators' task. It is important to recognise that the very existence of the banks is founded on a sound credit appraisal that allows them to lend to borrowers who are able to borrow from the capital markets only at a high cost. If honest bank officers try to play safe by lending only to topnotch companies, the effect would be an unviable business model because the banks' lending rates to these clients would barely cover their intermediation costs. Lending to less credit worthy customers at rates that reflect the higher risks is the foundation

of a healthy banking system. 1 SLR (Statutory Liquidity Ratio) securities consist predominantly of government securities.

A continued flight to quality in the banking system coupled with the continuance of directed credit would eventually convert the entire banking system into an instrumentality of government borrowing and priority sector credit. If the governance system of the banks (particularly the public sector banks) today is such that normal risk based lending has become managerially impossible, the time has come to change the governance system. The fundamental problems are with the ownership of the banking system. After a decade of reforms, it is increasingly apparent that the banking system needs to be privatised after a thorough cleaning up of the balance sheet and possible recapitalisation. Until this is done, all the other banking system reforms will remain incomplete.

Operational Reforms
At the same time as the financial health of the banking system were being tackled, several operational reforms were introduced in the realm of credit policy:

- Detailed regulations relating to Maximum Permissible Bank Finance were abolished
- Consortium regulations were relaxed substantially
- Credit delivery was shifted away from cash credit to loan method. However, the slack season credit policy of 2001 has reversed this shift.

These reforms have helped the efficiency of the financial sector and have also helped develop the money market in India. These reforms also have the potential to make the banking system more competitive and put pressure on the banks to become more efficient. This potential has not however been fully realised as the regulatory regime continues to be anti-competitive as discussed in 3.6 and 3.7 below.

Financial Institutions

It could be said that while at the beginning of the reforms, the banking system faced imminent insolvency but the financial institutions were more or less solvent, the roles were completely reversed after a decade of reforms.

Economic reforms deprived the development financial institutions of their access to cheap funding via the statutory pre-emptions from the banking system. They were forced to raise resources at market rates of interest. Concomitantly, the subsidized rates at which they used to lend to industry gave way to market driven rates that reflect the institutions' cost of funds as well as an appropriate credit spread. In the process, institutions have been exposed to competition from the banks who are able to mobilize deposits at lower cost because of their large retail branch network. The immediate impact of the reforms has been felt on the asset quality of the financial institutions. They have been the victims of sever adverse selection as these institutions have tended to become lenders of last resort to projects that cannot raise finance in the capital markets or from other sources. Moreover, the historical asset base of these institutions exposed them to precisely those sectors of the economy that

have been the losers in the reform process – the globally uncompetitive industries that owed their survival to the high degree of protection in the pre-reform era. As a result, the financial institutions have faced mounting levels of non performing assets that could pose a severe threat to their solvency.

Responding to these changes, financial institutions have attempted to restructure their businesses and move towards the universal banking model prevalent in continental Europe. It is difficult to say whether this would only replace a weak financial institution with a weak bank.

What is clear is that neither the government nor the regulator appears to be tackling the problems of this sector with the seriousness and urgency that they deserve. Radical reforms are called for in this sector including drastic restructuring, downsizing of the balance sheet, possible recapitalisation and eventual privatisation.

Insurance

Private sector insurance companies started operating in India in 2000, several years after the first proposal to allow their entry. The Insurance Regulatory and Development Authority (IRDA) has been set up as the apex regulator for this sector. It is still too early to assess the likely impact of the new players. In the first few months, however, the new entrants do appear to have injected greater competition and dynamism into India's insurance industry. The IRDA has also embarked on a regulatory programme that encourages greater professionalisation and modernisation of this sector. It has taken commendable initiatives for training and certification of insurance agents and for encouraging the development of an actuarial profession. In the past, bright students who were attracted to the actuarial profession by its potential to apply mathematical concepts to real life problems discarded the idea because of the total lack of scope for actuaries in India's nationalised insurance industry.

The major area where insurance reforms have not been sufficiently far reaching is in the area of investment restrictions. Sections 27 and 27A of the Insurance Act place restrictions on investments in shares and corporate bonds. Not only are the quantitative ceilings unnecessarily restrictive, but the qualitative restrictions are not in tune with a modern capital market. For example, the eligibility conditions for corporate debt do not involve the notion of credit rating at all, but depend on quite meaningless backward looking notions of financial soundness.

The key question that remains to be seen is how receptive the regulatory regime would be to financial innovation. The IRDA could play a catalytic and facilitating role here though the restrictive features of the Insurance Act would restrict its freedom. Of particular importance would be the regulatory stance towards capital market linked insurance products like variable life and universal life policies. The Life Insurance Corporation has introduced a variable life policy called Bima Plus. Unlike in the United States where such products are subject to regulation as mutual funds by the securities regulator also, Bima Plus appears to be regulated only as an insurance product and not as a mutual fund. Whether this would spur innovation or lead to regulatory arbitrage remains to be seen.

Competition and Efficiency

Early in the reforms process, it was recognised that greater competition and innovation would be required so that the public received better financial services. In its mid term review of the reform process (Ministry of Finance, 1993), the government stated: "Our overall strategy for broader financial sector reform is to make a wide choice of instruments accessible to the public and to producers. ... This requires a regulatory framework which gives reasonable protection to investors without smothering the market with regulations. ... It requires the breaking up of monopolies and promotion of competition in the provision of services to the public."

Unfortunately, this is one area where actual progress has lagged far behind stated intent. It is true that some steps have been taken to increase competition between financial intermediaries both within and across categories. Banks and financial institutions have been allowed to enter each other's territories. Fields like mutual funds, leasing, merchant banking have been thrown open to the banks and their subsidiaries. The private sector has been allowed into fields like banking and mutual funds. Nevertheless, major structural barriers remain:

- All major banks and financial institutions continue to be government owned and government managed.
- The entire mechanism of directed credit and selective credit controls built up over the years is still in place, and is being strengthened in certain areas.
- Financial intermediaries have often been compelled to set up separate arms' length subsidiaries while entering various segments of the financial services industry. This has prevented them from benefiting from economies of scope.
- Competition has also been hindered by the undiminished power of cartels like the Indian Banks Association (IBA). In fact, these cartels have been accorded the tacit support of the regulators. These half hearted attempts at promoting competition raise fears about the extent to which our regulators have succumbed to regulatory capture by the organizations that they are supposed to regulate.
- On the technological front, progress has been slow in important areas. The payment system continues to be primitive despite the central bank's attempts to create an Electronic Fund Transfer System (EFTS). Archaic elements of the telecom regulations have prevented the financial services industry from benefiting from the confluence of communications and computing technologies.

If we imagine a Rip Van Winkle going to sleep in the early 1990s and waking up today, he would not see that much has changed at the grass roots level in the provision of banking services. (The most visible change would be the much greater spread of credit cards – a financial innovation that has little to do with regulatory action). The extremely slow progress in this area means that the Indian consumer has not seen the benefits of financial sector reforms in the form of better service, better

products or better prices. The efficiency gains of financial sector reforms have simply not happened.

Pro-Bank Tilt of Regulatory Policy

One of the distinctive elements of the financial sector policy is a powerful regulatory protection extended to the banking system. Faced with a financially weak banking system, the policy makers have been unwilling to bite the bullet and recapitalise the predominantly state owned banks to restore their financial health. Instead the policy has been to provide a cosy regulatory regime in which the dominant oligopolistic banks are insulated from competition from new entrants as well as competition from non bank sources of capital. The implicit hope has been that this protected environment will allow them to survive even if they are financially weak.

- The nature and pace of banking sector reforms has been designed to reduce the ability of new banks to take market share away from the incumbents by aggressive competition. I would like to mention in particular the niggardly rate at which new bank licences have been doled out, a licencing policy that effectively excluded most promoters with deep pockets, the extreme restrictions on branch expansion and rationalisation, and ill concealed regulatory hostility to innovation and aggressive marketing. All this meant that the incumbent big banks faced very little threat from new entrants.
- At the same time, potential competition from outside the banking system was ruthlessly destroyed_ The development financial institutions that were financially very sound at the beginning of the reform process were not allowed to transform themselves into universal banks until their financial strength had been substantially eroded. This issue is described in more detail in 3.4 above. The non bank finance companies (NBFCs) that despite their higher cost of funds competed intensely with the banks on the basis of speed, flexibility and innovation were systematically destroyed in the second half of the nineties. In line with international practices, the NBFCs' access to retail funds was severely curtailed. At the same time, the regulatory regime did not allow the NBFCs to fund themselves effectively in the wholesale markets as they do globally.

The very hesitant moves towards capital account convertibility described in 2.2 above have meant that the banks have not had to face cross border competition on the scale that might have been expected in the early 1990s. Moreover restrictions on foreign banks operating in India have made them less of a competitive threat than they might otherwise have been. _ The regulatory regime for money market mutual funds has been designed to prevent them from competing effectively with the banks.

The capital markets have been in a state of decline since the early/mid 1990s for a variety of reasons as described in 5.9 below. However, one of the contributory factors has been a regulatory bias towards the banks and against the capital markets. This has taken several forms including limiting the amount of bank credit to the capital market, unwillingness to allow exchange clearing houses and depositories direct access to the payment system, and an ongoing attempt to keep the government securities market a

private inter-bank affair. More important than all these however has been the systematic tendency of the central bank to drain liquidity from the capital markets in situations similar to those in which central banks elsewhere in the world tend to flood the market with liquidity. While the US capital markets have benefited from what has been called the "Greenspan put", the Indian markets have been plagued by what may be called the "RBI call". One final point is that while the scams of 1992 and 2001 both originated in the banking system and then the contagion spread to the capital markets, the regulatory response in both cases was to crack down on the capital markets. This smear strategy has certainly worked to the advantage of the banks.

The net result of this extremely supportive regulatory regime has been that the weaknesses of the banking system have been masked. It has been possible to keep the explicit cost to the government of banking sector reform quite low (2% of GDP) while the economy has borne a far greater cost in terms of inefficiency and lack of competition. It would indeed be far better for the nation as a whole that the government incurs a larger direct cost of maybe 5-10% of GDP to clean up the banks thoroughly. It would then be possible to replace the current probank tilt of regulatory policy by a pro-competition tilt. The nation as a whole would surely benefit from a healthier and more competitive banking system.

Interest rate deregulation and financial repression

Deregulation

Perhaps the single most important element of the financial sector reforms has been the deregulation of interest rates.

- Interest rates were freed on corporate bonds, most bank lending, and on all bank term deposits.
- Introduction of auctions coupled with reduced pre-emption led to more market determined interest rates for government securities.
- Administered interest rates in the banking system are now confined mainly to the rate on savings account, and the concessional lending rates for certain sectors like exports and small loans. The interest rates on small savings instruments offered by the government are also administered, and in a sense provide a floor for bank deposit rates. The government is in the process of linking these rates also to market interest rates and inflation rates.

Financial Repression

For all practical purposes, financial repression is a thing of the past. One crude measure of repression can be got by comparing the inter bank call market rate (which was more or less free market determined even in the 1980s) with the short term bank deposit rate. From 1981-82 to 1992-93, the call rate exceeded the one year bank deposit rate in every single year with a median excess of 1.5%. From 1993-94 to 1999-00, the situation was reversed: the bank deposit rate exceeded the call rate in 5 out of 7 years, and the median excess of the deposit rate over call rate was 1.6%. This suggests that in the 1980s, the bank deposit rate wasrepressed to the extent of about 3%.

When the prices of financial assets are determined by the free play of market forces, financial markets are able to perform the important function of allocating resources efficiently to the most productive sectors of the economy. To the extent that this has happened in India, this must count as one of the most enduring and decisive successes of the financial reforms. It must however be added that as discussed elsewhere in this paper, the regulators have a tendency to use several indirect tools (including at times "moral suasion") to influence the direction of the market even after administrative controls have been removed. When this happens, many of the benefits of free financial markets are lost.

Capital Markets

The initial burst of economic reforms included a major reform in the capital market – the abolition of capital issues control and the introduction of free pricing of equity issues in 1992. Simultaneously the Securities and Exchange Board of India (SEBI) was set up as the apex regulator of the Indian capital markets. The last decade has seen several significant reforms in the capital markets. The secondary market in particular was completely transformed by technology and competition.

Paradoxically, however, after a decade of reforms, the capital market is less important in the financial system than it was at the beginning of the 1990s. It bears an eerie resemblance to a spanking new shopping mall with the best facilities and infrastructure, but no shoppers in sight. In some ways, the problems are with the real economy. As long as there is vibrancy in the real economy, there is life in the capital markets, but when the real economy itself descends into a spiral of diminishing expectations, it becomes difficult to sustain the vitality of the capital markets. These issues are discussed below.

Secondary Market Reforms

The secondary markets for stocks witnessed more change and reform than most other components of the financial sector:

- Online trading (the electronic order book) was introduced by the newly set up National Stock Exchange in 1994 and was quickly copied by the other exchanges. The capital market was previously confined to Mumbai (where the largest stock exchange was located) and to a few other centres where smaller exchanges provided poorer execution quality. Within a few years, this gave way to a national market based on satellite communications that abolished geographical barriers. Amongst the benefits were superior liquidity, greater transparency and lower costs.
- The settlement of securities became electronic in the late 1990s. Compulsory dematerialisation was introduced for deliveries in the stock market for institutional investors in 1998 and for retail investors in 1999. Today, practically all the securities settlement in the stock exchanges is in dematerialised form. The benefits have been in the form of faster settlement, lower costs and the elimination of forged and fake shares.

- Rolling settlement on a T+5 cycle was introduced in mid-2001. A decade ago, the settlement was on an erratic fortnightly cycle where settlements were often delayed. The system is still in the process of adapting to the new regime. The settlement period is to be shortened to T+3 in April 2002.
- A derivatives market was established in mid-2000. Initially, this was limited to index futures, but subsequently, index options and individual stock options have been added. This was accompanied by the abolition of the carry forward system that provided limited hedging facilities in the pre-reform era.
- Tighter enforcement of margins and the creation of a central counterparty diminished the risk of settlement failures. In the early 1990s, the long settlement cycle and poor enforcement of margins often led to defaults and settlement failures. In some cases, these defaults also led to the closure of the exchange.
- Internet trading (and mobile trading) have been launched, but are yet to pick up significant volumes. These have the potential to abolish geographical barriers to investors accessing broking services, just as electronic trading abolished geographical barriers to brokers accessing the stock exchange. They have the potential to further reduce costs, promote competition and improve investor service.

A few things still need to be done to complete the modernisation of the stock markets. These include:

- It is necessary to streamline the system of securities lending. Securities lending scheme was introduced in India in 1997. However, to allay the exaggerated fears of the tax authorities about its potential use as an instrument of tax planning, it was hemmed in with excessive restrictions. The result has been that the securities lending activity in India has been highly oligopolistic and ineffective.
- It is necessary to dismantle the short sale restrictions that plague the Indian capital market today. As discussed later in this paper, short sale restrictions are probably the single biggest culprit in recent episodes of alleged market manipulation.

Primary Market

As already mentioned, the first big bang reform in the capital market was the abolition of capital issue controls and the introduction of free pricing. Some elements of merit based regulation still survived in terms of track record requirements (entry norms) and an invidious distinction between premium and par issues. Over time, however, these have also been whittled down and the capital market regulator has moved almost completely to a disclosure based regime of regulation.

The introduction of the book-building route has led to greater efficiencies in the capital raising process and has contributed to improved price discovery. At the same time vast improvements in the disclosure regime discussed later in this paper have laid the foundation for a more transparent primary market.

There is still an element of dirigisme in the attitude of SEBI towards new financial instruments. It was only recently that SEBI allowed non investment grade bonds to be issued and it even now frowns on instruments like equity index linked bonds.

Disclosure Standards

Disclosure standards in the primary market have seen a gradual but steady improvement. However, the full benefits of this have not been realised because only a small fraction of investors receive the full prospectus. The current regulations require companies to provide an abridged prospectus to all investors, while the full prospectus is available on demand. In practice the on-demand availability of the full prospectus is geographically limited and is often restricted to the larger more sophisticated investors. Regulators have sought to deal with this problem by requiring more information to be reproduced in the abridged offer document, but this leads to information being crammed in fine print on one huge sheet of paper. It appears that the abridged prospectus has its origins in the era of price controls when issues were often oversubscribed a hundred or even a thousand times. At that time, it could be legitimately argued that it would be prohibitively expensive to provide every applicant with an unabridged prospectus. In today's vastly altered scenario, it should be possible for market intermediaries to ensure that every applicant has received a copy of the complete prospectus accompanied by a complete set of financial statements. It is necessary to move in this direction. One possibility would be a regulation that gives any applicant who has not received the full prospectus the right to withdraw his application at any time before allotment. This would incentives the issuer to ensure delivery of the full prospectus to every applicant.

Even more than in the offer document, it is in the area of continuing disclosures that the greatest progress has been made. Five key accounting standards, which have become effective from April 1, 2001, redress the most glaring inadequacies that existed previously in Indian accounting practices. These include the critical areas of consolidation of accounts of subsidiaries, deferred tax accounting and related party disclosures. There are still a number of areas where Indian accounting standards lag behind international best practices, but these are less important than the ones that have been redressed. Moreover, there is reason to hope that these deficiencies will also be removed over a period of time. At the same time, the accounting scandals surrounding the bankruptcy of Enron Corp in the United States have heightened the sense of urgency of adopting global best practices in accounting standards.

There has also been some progress in requiring companies to make disclosures to the stock exchanges in respect of any material developments like mergers, acquisitions, corporate actions, strategic decisions and other events that have a significant impact on the share price. However, both the content and the timeliness of these disclosures leave much to be desired. There have been some initiatives to make effective use of information technology in the collection and dissemination of corporate disclosures (Securities and Exchange Board of India, 2000) on the lines of the EDGAR system in

the United States. However, these have yet to move beyond the stage of conceptualisation.

Takeovers

The SEBI regulations on takeover have brought about a transparent regulatory framework for takeovers. However, there have been only a handful of hostile takeover bids in the last several years and most of these hostile bids have been defeated. That this should be so in a period of rising investor dissatisfaction with the governance and performance of the Indian corporate sector is both surprising and distressing. More than the deficiencies in the take over code itself, it is the major weaknesses in the financial sector that have led to this unsatisfactory state of affairs. In particular, the limited availability of leveraged financing in India, the regulatory bias against innovative financial instruments, and the general climate of political hostility to corporate raiders are to blame.

Institutionalisation

Extent of Institutionalisation

The post reform period has seen the emergence of a large number and variety of institutions in the capital market

- *Foreign Institutions:* Foreign Institutional Investors (FIIs) registered with SEBI enjoy a high degree of capital account convertibility in an otherwise closed capital account. FIIs are allowed to buy and sell shares in the stock exchange and repatriate the proceeds freely to their home countries. FIIs, as the name suggests, are institutions like mutual funds, pension funds, banks and insurance companies. However, there is a provision for a corporate or high net worth individual to also avail of the same benefits by coming in as a registered sub account of a registered FII. There are restrictions on the aggregate holding of FIIs in any company. As on December 31, 2001, FIIs had in the aggregate invested $14.5 billion in the Indian market. This would represent about 15% of the market capitalisation, but it must be noted that the figure of $14.5 billion is the cumulative amount of money brought into India and not the current market value of their portfolio.

No estimates are available of this portfolio value. However, since the market index has fallen sharply in dollar terms since the early 1990s, there is reason to believe that the FII equity holding would be less than 10% of the market capitalisation.

- *Mutual Funds:* In the late 1980s, the mutual fund industry (which till then consisted only of the public sector Unit Trust of India) was thrown open to the public sector banks and financial institutions. In the mid-1990s, private sector mutual funds were permitted. As of September 30, 2001, the mutual fund industry had assets under management of Rs 1.02 trillion. This represents about 20% of the market capitalisation, but since 70% of the mutual fund assets are in schemes that are predominantly debt oriented, and another 17% are in balanced funds, the actual equity holding of the mutual funds probably amounts to only about 5-7% of the market capitalisation. In terms of the competitive structure of the industry, UTI accounted for 50% of assets under management, the private sector funds for 42% and the public

sector funds for 8%. In the last couple of years, private sector players have rapidly gained market share from other players.

Development Financial Institutions: In the pre-reform era, development financial institutions and public sector insurance companies provided a major component of long term finance for industry. Along with extending loans, these institutions often subscribed to the equity as well. In many cases, the loans were at subsidised rates of interest, but provided for conversion into equity at highly favourable rates. As a result, financial institutions have a significant shareholding in many large Indian companies. Given the historical background of these holdings, the financial institutions have often behaved like strategic investors rather than portfolio investors. There have been repeated suggestions for restructuring of these holdings including secondary market sales, auctions to strategic bidders, and transfer to mutual funds or other special purpose vehicles. There have also been suggestions that they should simply start behaving like portfolio investors. As discussed earlier in this paper, there is a need for a radical restructuring, downsizing and eventual privatisation of these institutions themselves.

Venture Capital Funds: SEBI has recently liberalised the regulations for venture capital funds and has also permitted foreign venture capital funds to operate in India. They will have the freedom to invest in unlisted companies with the full freedom to repatriate sale proceeds. These new regulations have been notified only recently and it will be some time before these investors start playing a major role in the capital markets.

Insurance Companies and Pension Funds: Private sector insurance companies have started operations only recently. The regulatory framework for pension funds is still under discussion. These institutions have therefore yet to make a impact on the capital market.

Institutional Contribution in Market Development

The contribution of institutional investors to the development and modernisation of our capital markets has been significant, but it has not been as great as one would have expected:

The institutional investors have played a major role in the professionalisation of the capital markets in India. Their demand for high quality analysis and information has helped spur the growth of these services in India. As little as 10 years ago, beta was unheard of outside academic circles, P/E ratios were regarded as esoteric tools, the financial press was very limited in circulation, and there were no earnings forecasts or other equity analysis. Today, the country boasts of a very vibrant financial press, a very active community of financial analysts, and a high degree of professionalisation of all capital market intermediaries. Much of this has been greatly helped by the growth of institutions that value quality of service more than personal relationships and trust.

However, the institutions have failed to provide a major impetus to capital market reforms. Both domestic and foreign institutions in India have resisted reforms as vigorously as other market participants. Reforms in India have been pushed forward by academics, by the financial press and by the policy makers (not necessarily in that order). Many of these reforms have had to be pushed through by regulatory fiat even where they were in the long run interests of the institutions themselves. In this sense, institutions have been as myopic in their response to capital market reforms as anybody else. Three examples would illustrate this phenomenon:

- Before India set up its first depository, institutions were most vociferous in their complaints about the risks and costs of the paper based settlement system. But when the depository started operations, they were most reluctant to start availing of its services until SEBI mandated that a minimum percentage of their holdings must be dematerialised. SEBI had to then go on to mandate that institutions could trade only in dematerialised form. (Later SEBI extended this fiat to all investors trading in stock exchanges).
- Institutions have also generally agreed that a shift from account period settlement to rolling settlement is desirable. However, they did not embrace the optional rolling settlement facility that was available for a long period before SEBI made rolling settlement mandatory.
- The institutions have long complained about the lack of hedging mechanisms in India. However, after the derivatives markets were set up, institutions have been reluctant to trade in it. Most observers believe that the success of the market would depend on its first attracting enough retail interest to entice the institutions into it.

Assured Return Schemes and Mutual Fund Solvency

A mutual fund is one of the institutions that, in theory, requires almost no risk capital (Merton and Perold, 1993). However, in India many mutual funds, particularly in the public sector operated schemes that guaranteed a minimum return. These were like bank deposits sweetened with a call option on the stock market, but many mutual funds failed to recognize the risks involved in these products. When the portfolios of these schemes did badly (partly due to poor management and partly due to the lacklustre performance of the market itself), the mutual funds had great difficulty in fulfilling their return guarantees. Under pressure from SEBI, the public sector banks and insurance companies that had sponsored these mutual funds provided financial support of nearly Rs 20 billion to the mutual funds to allow them to honour the guarantees. Of these seven mutual funds, one needed a support of Rs 12 billion, three needed about Rs 2 billion each, and three needed relatively small amounts2.

The Problems of Unit Trust of India

The biggest problem however was in the case of the largest and oldest mutual fund, the Unit Trust of India. The oldest of its schemes, US64, had over a period of time developed into a queer animal. It was an open-end scheme, but did not link its repurchase and resale prices to Net Asset Values (NAV). In fact, it did not report NAVs at all. For several years, repurchase and resale prices had been held fairly

steady while the fund paid out attractive annual dividends. By the early 1990s, many institutional and retail investors had come to perceive US64 as an attractive fixed income investment though the majority of its investments were actually in equities. Because of its liquid secondary market, many even regarded it as a money market instrument. This was fine as long as US64's NAV was significantly above its repurchase and resale value. This excess provided a safety cushion to absorb market fluctuations.

In the mid-1990s, however, it became clear to careful observers that this safety cushion was being eroded and that the scheme was exposed to a high degree of market risk. It was only in 1998 that UTI itself announced that it had a large deficit in US64; not only was the NAV below the resale price, it was below even par value. A run on the fund appeared likely as investors prepared to exit before the resale price was lowered to bring it in line with NAV. At this stage, the government undertook a bail out in which it paid UTI Rs 33 billion (the book value) for securities that had a market value of only Rs 15 billion. It was also decided to make the scheme NAV based over three years.

In mid 2001, a sharp drop in the Indian market pushed US64 into a large deficit again, but the government now indicated its unwillingness to bail out the institution. The fund then took the drastic step of suspending repurchase and resale of units under the scheme. At the same time, it opened a special liquidity package allowing any investor to redeem up to 3000 units at fixed pre-announced rates starting at Rs 10 for August 2001 and going up to Rs 12 in May 2003.

In January 2002, the scheme reopened for fresh subscription as an NAV based scheme where both purchases and sales are at NAV linked prices. At the same time for old investors, the government offered some relief. First, the facility of redemption at pre-announced rates ranging from Rs 10 to Rs 12 was extended from 3000 units to 5000 units. Second and more important, for holdings above 5000 units, UTI assured a repurchase price of Rs. 10 per unit, or NAV, whichever is higher on May 31, 2003. This assurance was backed by the Government which agreed that in the event of NAV in May 2003 being lower than the guaranteed repurchase price, it would compensate UTI for the difference. Thus after six months of vacillation, the UTI was bailed out by the taxpayer for the second time in four years.

The distinguishing feature of the Unit Trust of India is that it is *not* government owned. The government controls the organisation without owning it. The initial capital of UTI consisted of Rs 50 million of subscription by government institutions to US64 in 1964. This initial capital is not a separate share capital but is merely a part of US64 and even in early years, it was only a small part of US64. Thus the government was just the first of the millions of investors in US64. All the fixed assets3 including the land and buildings of UTI have been bought out of the funds of US64 and are shown as assets of US64. In this sense, the true owners of UTI are the US64 unitholders and the government controls the organisation only by virtue of the UTI Act and not by virtue of ownership.The logical solution to the problems that UTI found itself in would therefore have been for the government to withdraw from the scene by returning UTI to its rightful and legitimate owners – the holders of US64.

These owners would then have had the right to decide for themselves how their funds should be managed. The simplest way to achieve this demutualisation would have been for UTI to transfer all its buildings and other asset management related assets from US64 to a new company and to spin this company off to the US64 unit holders. The new company would have become the Asset Management Company (AMC) for all UTI schemes. The UTI Act could then have been repealed and UTI could have been brought under the SEBI Mutual Fund Regulations.

The US64 holders should have been allowed to do what they pleased with the shares that they would have received in the newly created AMC. They could sell them to anybody they choose or they could hold on to them. It was possible that a large domestic or foreign financial institution would have launched a tender offer for these shares to take control of the new AMC. They should be have been allowed to do so with no restrictions other than that imposed by the SEBI Takeover Regulations.

As a rule of thumb, an AMC is valued at 2-3% of assets under management. This would suggest that the new AMC would have been worth about Rs 10-15 billion. The large distribution network, valuable real estate and other fixed assets would probably have added several billion more to the valuation. Thus the shares in the AMC would have gone some way to compensating the US64 holders for the losses that they have suffered under government management. It would also have established the principle that the owners have the right to replace any management that performs badly even if that management is the government itself. Had this solution been adopted in mid 2001 (or even better immediately after the 1998 bailout), it would have avoided using taxpayer money to bail out the investors of US 64 in 2002/2003.

Market Manipulation

The 1990s have seen a number of episodes of alleged market manipulation in the equities market. Shah and Thomas (2001) identify eight significant episodes of alleged market manipulation during the 1990s in the Indian stock markets. There can be some difference of opinion on how many major market manipulation episodes have taken place because there is a tendency among Indian policy makers to regard a large price swing as market manipulation even if it is only a speculative bubble or even if it is justified by fundamentals. Nevertheless, there is no denying that many of the episodes enumerated by Shah and Thomas do provide cause for concern.

In my view, the single most important culprit for the frequency and severity of such episodes is the strong restrictions on short selling that exist in India. All institutions (including banks, financial institutions, mutual funds and foreign institutional investors) are prohibited from short selling in the Indian capital market. This restriction has been in place for a long time, but the restriction has become more serious with the progressive institutionalisation of the capital market in the 1990s. Over a period of time, therefore, an increasingly large and important segment of the market has been precluded from short selling. Moreover, at various critical junctures (most recently in March 2001), the regulators have moved to impose a total ban on short selling by all investors.

To understand why short selling restrictions are so important, we must first note that almost all the episodes enumerated by Shah and Thomas involve alleged attempts by the companies and their promoters to rig up the share prices of their own companies. In a free market, the most powerful weapon against such attempts would be aggressive short selling by rational investors. In the presence of short sale restrictions, however, the best that rational investors can do is to sell all their holdings. Once they have done so, they make no further contribution to price discovery. Market prices are then determined by the alleged manipulators and less rational investors (momentum investors and passive /indexed investors). It now becomes evident that short sale restrictions constitute an open invitation to promoters and managements to rig up the share prices of their own companies. Perhaps inadvertently, the regulatory regime has come to fulfill the fondest dream of these market manipulators.

Even if it were argued that some of these episodes are non-manipulative market crashes, short sale restrictions would be an important explanation for their number and severity. Recent studies in the United States (Hong and Stein, 2001) argue that short sale restrictions in that country are responsible for the high frequency of market crashes there. The mechanism is the same as that described above – short sale restrictions prevent rational bearish investors from contributing to price discovery in the build up to the crash. These studies are all the more important because part of the justification for short sale restrictions in India is derived from the fact that the United States has similar restrictions. It is often forgotten that the United States introduced these restrictions as a misguided knee jerk reaction to the great depression, and has merely persisted with that mistake. More importantly, if our markets are more susceptible to market manipulations than the US market, we should move more aggressively to remove these restrictions and pro-actively facilitate short selling.

In the United States itself, the scandals surrounding the bankruptcy of Enron have tarnished the reputations of the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), the auditors, the rating agencies, the analysts, the boards, the financial press and almost every other element of the regulatory regime. The one group that has come out with flying colours is the lowly short seller who kept pointing at the skeletons in Enron's cupboard when everybody else was intent on turning the other way. It is now apparent that even the United States would therefore benefit from relying on the market forces represented by the short sellers to police its markets.

Another important factor is the unwillingness of the stock exchanges and the regulators to embrace modern software tools for market surveillance and investigation. Despite a longstanding effort to implement stock watch systems, the stock exchanges have yet to make these systems fully effective. Most of the investigations into alleged market irregularities also fail to embrace the tools of information technology. There is a large pool of software talent in the country that could develop modern neural network and artificial intelligence tools that could leapfrog the best in the world. This has not happened.

There has been a tendency to imitate the US model of market surveillance without recognising that within the US itself, there is considerable disquiet about the model.

This was true even before the Enron scandal. As Oesterle (2000) points out in an incisive analysis: "Although the U.S. securities markets are the world's largest and most liquid, it does not follow that the regulatory system has been an unqualified success. Strong economic fundamentals have created and sustained financial markets, not NYSE policing of its floor traders. … A fairer assessment is that the SRO regime has proved to be barely adequate at best. … During quiet periods, the SEC largely relies on SROs to police trading floors, and it routinely approves SRO rules and disciplinary decisions. In other words, the SEC during such periods tends to be lazy and complacent. When a scandal breaks in a trading market, there is embarrassment and handwringing over why the exchange involved was not more vigilant in disciplining its members. The exchange contritely proposes minor rule modifications, often at the SEC's insistence, leaving the exchange's functions and membership largely intact. The SEC approves the changes and, with some fanfare, the regulators and the regulated hail the virtues of the SRO system— until the next scandal. In recent years the SEC has not been able to resist the temptation to tinker too much with the rules of the exchanges. But the illusion that the SEC is guaranteeing the integrity of exchanges removes an incentive for the exchanges themselves to exercise diligence, lest they lose their customers. And customers are lulled into a false sense of security, believing the SEC is closely policing the day-to-day activities of the exchanges."

There is a need to rethink the entire dirigiste model of regulatory surveillance and rely more on countervailing power in the market place. Abolition of short sale restrictions is one way of bringing countervailing power to bear. Another important step is greater transparency and disclosure. Using modern artificial intelligence methods it should be possible for the trading system to automatically generate alerts about suspicious trading patterns and price/volume trends. Rather than feed these alerts to a set of error-prone human surveillance officials (with potentially perverse incentives), these alerts should be publicly disseminated. By doing so, the information is placed in the hands of those who have every incentive to take corrective actions. If an automated surveillance alert indicates possible bear manipulation, the bulls are immediately forewarned to protect their own interests. These forewarned investors become a countervailing power to the power of the would-be manipulators. Such an approach would reduce the role of human discretion and replace this discretion by the impersonal logic of computing systems and free markets. This approach would also reduce the agency costs associated with the regulatory approach. I would argue that India with its abundant software talent is uniquely positioned to lead the world in such a process of development.

Regulation of Listed Companies and Investor Protection

Regulation of listed companies has been a major area of weakness in the Indian regulatory system. The legacy of regional stock exchanges is a major reason for this. The legal framework requires companies to be listed on the regional stock exchange closest to their location. After the advent of electronic trading in the mid-1990s, most of these regional exchanges have become defunct for all practical purposes. There are some exchanges where it is reported that there is nobody even to answer the phone. Yet these exchanges continue to be the front line regulator for the companies for

which they are the primary listing. The problem has been somewhat ameliorated by the fact that India's second largest exchange (the BSE) is the primary exchange of listing for a large number of important companies.

However, the competitive dynamics of the securities trading industry is such that a shift of market share away form the BSE to its larger competitor (the NSE) is quite plausible (Varma 2001).

In this situation, the entire framework of listing regulation needs urgent reconsideration. The time has come to consider the establishment of a National Listing Authority on the lines of the similar entity in the United Kingdom. Apart from the organisational issue, it is also necessary to strengthen the statutory basis for regulation of listed companies. Unfortunately, this debate has been cast in terms of empowering the regulators and has led to a dispute of jurisdiction between SEBI and the Company Law Department. I think the real task is that of empowering the shareholders and other investors. We need to put aside the dirigiste notion that the state is the answer to all problems of corporate governance. The goal should be to create a statutory framework under which violation of any SEBI regulation or listing requirement gives the investor the statutory right to sue the company and its management. The United States has used the mechanism of class action law suits to provide more effective investor protection than what any regulator could provide. We could try to replicate that model here or we could try to adapt the PIL (public interest litigation) mechanism that the Indian judiciary has used very effectively.

Investors are using the PIL route, but only to compel the regulators to take action. What is needed is a statutory sanction for a process in which investors can enforce their rights against companies without the intervention of the regulators at all.

Emerging Threat of Monopolies

Since the mid-1990s, investors and regulators have benefited from a high degree of competition in the Indian securities industry. Even more than all the policy changes that have taken place, it is technology and competition that have transformed the Indian capital market in the last 7-8 years. If we are unable to maintain this competitive structure of the securities industry, we will lose the single most important driver of capital market modernisation in this country. There is now considerable evidence that critical elements of the Indian securities industry are becoming significantly less competitive than in the past (Varma 2001).

Derivative Markets

In the course of just three months from February 2001 to April 2001, the derivatives market was transformed from a competitive duopoly to an effective monopoly. The BSE's market share was effectively wiped out in this short period. This was an awesome reminder of a well known fact: once an exchange's trading volume drops below a critical mass, a vicious circle ensues in which falling liquidity drives traders away causing liquidity to fall further. The speed with which this happens can take everybody by surprise. More importantly, clawing back lost market share is very

difficult. In August 2001, the BSE attempted to re-establish its derivatives market by effectively charging a negative transaction fee. The attempt failed.

Equity Markets

Indian equity markets witnessed a similar shift of market share from BSE to NSE during 1994-95. The newly started NSE took market share away from the established market leader to become the largest exchange in India. The vicious circle of falling liquidity should in normal circumstances have led to the NSE then taking the market away completely from the BSE. This did not happen for two reasons:

- BSE quickly adopted the electronic trading model introduced by the NSE.
- The differing trading/settlement cycles of the two exchanges meant that the product offerings of the two exchanges were not perfect substitutes. (From July 2001, the regime of differing settlement cycles has been done away with. This factor no longer operates).

Since early 2000, the market share of BSE in the combined trading volume of BSE and NSE has been falling steadily from near parity to 36% in December 2001. The BSE's market share is today probably at the borderline of the critical level where the vicious circle of falling liquidity begins to operate. The new regulatory regime that began in July 2001 makes stock markets far more intensely competitive than they were earlier. In this environment, a situation where two exchanges have comparable market shares is not a very stable one. Both exchanges have every incentive to try and push the other below the critical level at which it ceases to be viable. Competitiveness is therefore a moving target that requires a proactive management with the ability to respond swiftly to competitive threats and opportunities. It is at this juncture that the BSE finds itself in a situation where there is a governance vacuum. The old mutual governance structure has been swept away, but the promised demutualised governance is not yet in place. In this situation, the ability of the exchange to fight an intense competitive battle and survive is open to doubt. The possibility that the NSE's success in the derivative market could be replicated in the equity market is therefore a very real one.

Depositories

For the last few years, the market for depositories has been a contestable market struggling to become a competitive market. It is now becoming apparent that the second depository (CDSL) is at best a niche player and at worst a failure. The first depository (NSDL) has become an effective monopoly. The Depositories Act clearly envisages a competitive industry structure and provided for a regulatory regime in which the depository was not subjected to price regulation or minimum performance standards. From a theoretical point of view, this regulatory vacuum can be defended only on the ground that the market is highly contestable. For a couple of years after its inception, the market did appear contestable as CDSL waged a price war with NSDL and pursued market share aggressively. Even at the peak of its apparent success, however, what CDSL appeared to be doing was to target a niche market of active traders while leaving NSDL with an effective monopoly over most of the depository business. For reasons that are not fully clear, even this niche model appears to have got into serious trouble in the second half of 2001, but that is not very important. The

central argument here is that even in the best of times, CDSL was only a niche player and the depositories business was an effective monopoly.

Is the depository market even contestable? There appear to be significant switching costs for most investors to change their depository participant or depository. More importantly, the regulatory regime has unwittingly created large entry barriers. The key barrier is that the issuer company has to enter into an agreement with the depository and establish electronic connectivity with the depository before that depository can offer dematerialisation services in relation to that issuer. Another key barrier is that the software systems of the existing depositories are not designed with open interfaces to allow any new depository to establish connectivity with them easily and automatically.

Fostering Competition

Reduced competition would remove one of the most powerful positive forces in the Indian capital market. The force that has made our capital markets more investor friendly and provided cost and efficiency gains in the last decade would no longer be available. It is possible that much of what has been achieved in the last few years would be reversed, as monopolies become progressively unresponsive to investor needs.

Given the limited possibility of effective regulation of monopolies in the securities industry, the regulatory initiatives to foster competition are extremely important. Global experience suggests that securities trading is a highly contestable and competitive business (Beny and Jackson, 1999). Fostering competition in this area should be relatively easy (Biglari and Hunt, 2000). What is required is the willingness on the part of the regulator to license new stock exchanges with varying governance structures and market designs. For example, active encouragement to ECNs could be one way to maintain competition in the stock market.

Similarly, regulatory provisions that artificially preserve monopolies should be scrapped quickly. For example, section 13 of the Securities Contract Regulation Act prohibits two persons from entering into securities contracts (other than spot delivery contracts) except through a stock exchange. This section confers totally unwarranted and unjustified monopoly privileges on a stock exchange, and therefore, it needs to be repealed as soon as possible. It is interesting to note that while similar restrictions exist both in the United States and in the United Kingdom, these provisions serve an anti-competitive function there too. In the UK, this prohibition was introduced only after the end of the Second World War and was clearly seen by all concerned as a "reward" for the support that the London Stock Exchange had extended to the war effort. Similarly, in the US, it is now clearly recognised that the prohibition is a protectionist measure whose primary purpose today is to insulate American stock exchanges from foreign competition. In both cases, the "political economy" of this prohibition involves extraneous reasons quite unrelated to investor protection.

Similarly, the by-laws of the stock exchanges must be perused carefully to identify and repeal those that are anti-competitive in nature. Oesterle (2000) provides a good

description of how self-regulatory organisations (SROs) use their by-laws to stifle competition. The depository business on the other hand is significantly less competitive globally and is perhaps not highly contestable either. Nevertheless, I believe that regulatory interventions could make this business sufficiently contestable. But for this to happen our regulators would have to go beyond what regulators have done globally. The key is to reduce switching costs for investors and depository participants and to ensure fast and easy inter-connectivity for a potential new depository. The crucial hurdles here are at the software end, and I believe that the regulators would have to extend their oversight to software source code to make this happen. The source code4 for the key interfaces of the depository must be regarded as part of its by-laws and subjected to the same level of public scrutiny and regulatory oversight.

It might be objected that this would require the depositories to give up their intellectual property in the software created by them. This is not necessarily so. With modern object oriented methodologies, it is possible to hide the actual implementation of most of the software while exposing all the important interfaces to public scrutiny. It should be possible to subject these interfaces to regulatory oversight without compromising the intellectual property of the bulk of the software. While I make no attempt to hide my personal commitment to open source software, the proposal being made here does not require the regulator or the regulatee to embrace the open source movement.

Indeed this must happen not just for depositories but for stock exchanges and other similar oganisations that constitute the infrastructure of the capital markets. The ultimate source of competition to the Indian securities industry would be from outside the country. As and when the country becomes more open on the capital account, incumbent monopolies would face intense competition from global exchanges as well as clearing and settlement agencies. However, it is imprudent to rely only on this source of competition.

First, on current indications, an open capital account appears to be a distant destination despite the mention that it finds in the Finance Minister budget speech for 2002-03. Second, a highly competitive domestic industry would be more likely to withstand global competition when it does arrive (Porter, 1990). To tolerate monopolies today would be to risk the complete domination of the Indian securities industry by foreign players when do we open our markets to global competition.

Status of the Capital Markets

In the early years of the reforms, the Indian capital markets continued to display the growth and vibrancy that have been present since the mid-1980s. However, this soon petered out, and the capital markets ended a decade of reforms at a lower level on most dimensions than at the start of the reforms. In retrospect, it is evident that the eight years beginning 1984 was the golden age of the Indian capital market.

- During the period from January 1984 to October 19925, the market delivered a compounded annual return of about 32% in rupee terms (the market index went up more than 11 times) and 16% in dollar terms (the dollar adjusted index went

up nearly 4 times). By contrast, during the two decades from 19656 to 1984 the market had delivered a compounded annual return of less than 6% in rupee terms and less than 1% in dollar terms.

- A major contribution to the stellar performance of the stock market during the golden years came from a sharp rise in the price-earnings ratio. From a level of around 6-7 in the early 1980s, the P/E ratio doubled in the second half of the 1980s and doubled again in the next couple of years.
- As a consequence of this explosive growth, a number of investors were attracted to the capital market. The capital market that used to attract only about 3% of household financial savings in the 1970s and early 1980s absorbed 10% of household financial savings by the end of the 1980s. This figure rose to a whopping 23% in 1991-92.
- The capital market also became a major source of financing for the corporate sector. Money raised in the capital markets accounted for only 1% of gross fixed capital formation in the economy in the 1970s and early 1980s. This figure rose to 6% by 1990 and peaked at 13% in 1993-94.
- Rising prices and large new flotations (including limited partial privatisation of some public sector enterprises) raised the market capitalisation to nearly 50% of GDP in the early and mid-1990s as compared to less than 20% at the beginning of the 1990s. Most of this growth stopped or reversed in the later half of the 1990s:
- At the end of February 2002, the market index in rupee terms was only about 7% above the post scam levels of October 1992. The average market index during the first eleven months of 2001-02 was almost exactly the same as in Oct. 1992. This means zero return in rupee terms in about 9 years. In dollar terms, the average index in the first eleven months of 2001-02 was less than half of what it was in Oct. 1992. A foreign investor investing in Indian stocks just as the country was opening up to foreign capital would have lost half his capital.
- The poor performance of the stock market during the post reform period is due principally to a sharp fall in the price-earnings ratio. In the last couple of years, the P/E ratio has halved from the levels of around 30 reached in the early years of the reforms. The P/E ratio is now back to pre-reform (late 1980s) levels.
- The share of household financial savings flowing into the capital market (which had reached 23% in 1992) fell back to about 5% by the late 1990s. This is approximately the same level as in the early 1980s, and sharply lower than in the late 1980s and early 1990s.
- Capital raised in the primary market as a percentage of Gross Fixed Capital Formation in the economy (which reached 13% in 1993-94) fell back to about 2% by the end of the decade. This is about the same level as in the mid-1980s.
- The market capitalisation in absolute rupee terms stagnated in the second half of the 1990s (except for a spectacular but transient surge during the technology stock boom of 1999 and 2000). As a percentage of GDP, the market capitalisation fell to below 30% by the end of 2000-01 (and to about 25% by the end of 2001). This means that market capitalisation relative to GDP is not significantly higher today than before the reforms.

The only quantitative dimension on which the stock market appears better today than at the beginning of the reforms process is trading volume. Trading volume was only

about 25% of market capitalisation throughout the first half of the 1990s. This figure surged to over 150% by the end of the 1990s, and in 2000-01 it reached a spectacular figure of over 400%, propelled in part by the boom in technology stocks. In 2001-02, trading volumes fell sharply from the stratospheric levels seen in 2000-01, but recovered in subsequent months as the markets gradually adapted to the structural changes in the market. During the first nine months of 2001-02, trading volumes averaged about 140%, which is about the same as the levels prior to 2000-01. All this is not to suggest that economic reforms have been bad for the Indian capital market.

Quite the opposite is true. India is a good example of Paul Krugman's thesis that "the financial markets offered an immediate, generous advance on the presumed payoff" from economic reforms (Krugman, 1995). Financial markets believe that reforms would pay off in the long run and are therefore willing to provide lavish rewards for economic reform in the belief that a wave of reform is unstoppable. Stock markets thus tend to reward reformers long before they have completed their job. Markets are forward looking and share prices respond to respond to expectations of future reforms. In the Indian case, these expectations turned out to be somewhat premature.

The market responded enthusiastically to the first whiff of liberalisation in the mid-1980s, and even more euphorically to the major reforms of 1991. The rise in prices in this period reflected not merely the reforms that had been put in place, but also those that were expected to follow in logical progression. As reforms stalled after the securities scam of 1992, the markets performed badly. Looked at this way, the golden age of the Indian capital market during 1984-92 were simply the period in which reforms were actually taking place and were expected to continue. The stagnation since then reflects the slowing down and reversal of the reform process since then.

Monetary policy and debt markets

In the early nineties, the Indian debt market was best described as a dead market. Financial repression and over-regulation were responsible for this situation (Barua et al., 1994). Reforms have eliminated financial repression and created the pre-conditions for the development of an active debt market:

- The government reduced its pre-emption of bank funds and moved to market determined interest rates on its borrowings. Simultaneously, substantial deregulation of interest rates took place as described earlier.
- Automatic monetization of the government's deficit by the central bank was limited and then eliminated by abolishing the system of *ad hoc* treasury bills. Several operational measures were also taken to develop the debt market, especially the market for government securities.
- withdrawal of tax deduction at source on interest from government securities and provision of tax benefits to individuals investing in the
- Introduction of indexed bonds where the principal repayment would be indexed to the inflation rate.
- setting up of a system of primary dealers and satellite dealers for trading in government securities
- permission to banks to retail government securities

- opening up of the Indian debt market including government securities to Foreign Institutional Investors. With all these measures, most of the institutional structure for the growth of the money market is now in place. Primary dealers, satellite dealers, rating agencies, transparent trading facilities, gilt mutual funds and a host of other institutional initiatives have created the preconditions for a deep and vibrant money market. Despite all this, a series of policy shocks during the l990s stalled the development of the money market until the end of the decade:
- The securities scam of 1992 was the first major shock to the money market. This scam centred upon repo transactions8 in the government securities market. The repo is one of the safest and most important instruments in any money market anywhere in the world. Unfortunately, the regulatory response to the scam was a ban on repos in the government securities market in India.. Liquidity in the government securities market virtually dried up, and recovered only gradually as the ban on repos was relaxed over a period of several years.
- Just as the market was coming out of the stupor following the scam, the busy season credit policy of 1995 played havoc with the money markets. In 1995, the RBI (possibly under pressure from the government) decided to use monetary policy to stamp out the inflation that was raising its head. The sharp monetary squeeze lasted only half a year before it was substantially eased in the slack season policy of 1996. But in February and March 1996, interest rates went through the roof, and top rated companies and institutions had difficulty raising funds even for short maturities. Borrowers who were below the top rung found the money market effectively closed to them. A number of defaults (euphemistically described as rollovers) took place during this period. The hard blow to the money market was exacerbated by the way in which the central bank chose to conduct the management of the public debt. The sharp monetary squeeze (which the market expected to be temporary) had led to a strongly inverted yield curve in the free market. This posed a problem for the periodic auction of T-bills. Left to the free market, cut off yields on these T-bills would have surged to unacceptable levels. At some of these auctions, therefore, the RBI rejected all competitive bids, accepted the non-competitive bids at the cut-off rate determined by it and let the rest of the T-bills devolve on itself. (Some entities are allowed to bid only on a non-competitive basis where they have to accept the cut-off yield). The unintended consequence of this was that the market for floating rate instruments (tied to the T-bill rate) was virtually destroyed. As short-term rates in the free market rose above 20% and T-bill cut-off rates were kept around 10%, floating rate bonds started sinking. The market was wiped out and some intermediaries who performed market making in these instruments suffered heavy losses as well.
- After recovering from the shocks of 1995-96 the money market were perhaps ready to take off when the Indian rupee came under downward pressure in the wake of the Asian crisis around August 1997. The government at this point decided to defend the rupee though some influential economists argued that a depreciation of the currency would improve our global competitiveness. The government's decision was based on the belief that a sharp fall in the rupee would weaken international confidence in the country. Since the government wanted to conserve its foreign exchange reserves, interest rates became the

principal weapon for defending the rupee. On several occasions in 1997 and 1998, the Reserve Bank squeezed liquidity sharply to bolster the currency. The most dramatic of these episodes was in the middle of January 1998: T-bill yields more than doubled, and some prominent money market institutions lost more money on that single day than they had made in the whole year. Episodes like this were repeated throughout the year. After India conducted nuclear tests at Pokharan in May 1998, the RBI was forced to tighten liquidity once again to prevent a slide in the currency. Again in August 1998, just as the Resurgent India Bonds were being launched, the rupee came under renewed pressure, and the RBI had to suck liquidity out of the system very sharply. Between August 1997 and August 1998, the Indian yield curve inverted and disinverted three or four times. All this turbulence took a severe toll on the money markets and the institutions that operate in it. After August 1998, the money markets enjoyed a period of relative calm. Since then, there has been a sharp rise in the liquidity in money markets instruments and government securities. The turnover in the wholesale debt market of the NSE rose from about 25% of market capitalisation to over 100% of market capitalisation (see Chart 8). Short-term interest rate benchmarks like NSE MIBOR established themselves and a well defined yield curve began to emerge. Primary dealers and fixed income mutual funds brought a set of active traders into the markets. By 2001, the money markets and government securities markets were more liquid than they had been at any time since the scam of 1992.

There is still a long way to go but India is perhaps closer to the development of a vibrant debt market than ever before. To my mind, the fundamental task now is that of regulatory mindset. It appears to me that the regulator in the pursuit of its policy goals has often tended to act against the market rather than through the market. It has tended to fight the market rather than guide it along the desired path. It has tended to use market distorting interventions rather than market oriented ones. The money market is the arena where the full force of the central bank's monetary policy is felt, and the manner in which the central bank conducts its monetary policy is therefore of great importance. I believe that the regulator should have greater confidence in the efficacy of the price signal in free functioning markets, and should place a little more emphasis on the maintenance of orderly markets. It would then be able to achieve most of its policy objectives without sacrificing the growth and development of the money markets.

Finally, a vibrant corporate debt market cannot emerge until major legal reforms are accomplished in areas like bankruptcy, foreclosure laws, and stamp duties.

Impact on the corporate sector

Scope of Corporate Finance

Before the reforms, corporate financial management in India was a relatively drab and placid activity. There were not many important financial decisions to be made for the simple reason that firms were given very little freedom in the choice of key financial policies. The government regulated the price at which firms could issue equity, the rate of interest that they could offer on their bonds, and the debt equity ratio that was permissible in different industries. Moreover, most of the debt and a significant part of the equity was provided by public sector institutions.

Working capital management was even more constrained with detailed regulations on how much inventory the firms could carry or how much credit they could give to their customers. Working capital was financed almost entirely by banks at interest rates laid down by the central bank. The idea that the interest rate should be related to the creditworthiness of the borrower was still heretical. Even the quantum of working capital finance was related more to the credit need of the borrower than to creditworthiness on the principle that bank credit should be used only for productive purposes. What is more, the mandatory consortium arrangements regulating bank credit ensured that it was not easy for large firms to change their banks or vice versa.

Firms did not even have to worry about the deployment of surplus cash. Bank credit was provided in the form of an overdraft (or cash credit as it was called) on which interest was calculated on daily balances. This meant that even an overnight cash surplus could be parked in the overdraft account where it could earn (or rather save) interest at the firm's borrowing rate. Effectively, firms could push their cash management problems to their banks. Volatility was not something that most finance managers worried about or needed to. The exchange rate of the rupee changed predictably and almost imperceptibly. Administered interest rates were changed infrequently and the changes too were usually quite small. More worrisome were the regulatory changes that could alter the quantum of credit or the purposes for which credit could be given.

In that era, financial genius consisted largely of finding one's way through the regulatory maze, exploiting loopholes wherever they existed and above all cultivating relationships with those officials in the banks and institutions who had some discretionary powers. The last decade of financial reforms have changed all this beyond recognition. Corporate finance managers today have to choose from an array of complex financial instruments; they can now price them more or less freely; and they have access (albeit limited) to global capital markets. On the other hand, they now have to deal with a whole new breed of aggressive financial intermediaries and institutional investors; they are exposed to the volatility of interest rates and exchange rates; they have to agonize over capital structure decisions and worry about their credit ratings. If they make mistakes, they face retribution from an increasingly competitive financial marketplace, and the retribution is often swift and brutal.

Broadly the corporate sector has felt the impact of financial sector reforms has been felt in the following key areas:

Corporate governance

In the mid nineties, corporate governance became an important area of concern for regulators, industrialists and investors alike. Indian industry considered the matter important enough for them to propose a model corporate governance code (Bajaj, 1997). SEBI introduced a mandatory governance code based on the recommendations of the Birla Committee (Securities and Exchange Board of India, 1999). However, the major pressure for better corporate governance came from the capital markets (Varma, 1997). The decade since the beginning of reforms have witnessed a silent revolution in Indian corporate governance where managements have woken up to the disciplining power of capital markets. In response to this power, the more progressive companies are voluntarily accepting tougher accounting standards and more stringent disclosure norms than are mandated by law. They are also adopting more healthy governance practices.

Risk management

The deregulation of interest rates as a part of financial sector reform made interest rates highly volatile. Companies have tried to protect themselves from this risk by introducing a call provision in their bonds by which they can redeem the bonds prematurely under certain conditions. Of course, such call options make the bonds more expensive (in terms of a higher coupon rate) or more difficult to sell. Companies have also tried to make the bonds more attractive to investors by giving them a put option to seek premature redemption of the bonds. This may make the bond easier to sell, but it exposes the issuing company to interest rate risk. In the post reform era, corporates have also been faced with high volatility in foreign exchange rates. The rupee-dollar rate has on several occasions moved up or down by several percentage points in a single day as compared to the gradual, predictable changes of the eighties. Indian companies have found to their dismay that foreign currency borrowings which looked very cheap because of a low coupon rate of interest can suddenly become very expensive if the rupee depreciates against the currency in which the bond is denominated.

Capital structure

At the beginning of the reform process, the Indian corporate sector found itself significantly over-levered. This was because of the availability of subsidised institutional finance and the lower operating (business) risks in a protected economy. As the corporate sector was exposed to international competition and high real interest rates, Indian companies undertook substantial deleveraging in the mid-1990s. But for a flagging equity market since the mid- 1990s, many companies might have travelled further down this road.

Group structure and business portfolio

Indian business groups have been doing serious introspection about their business portfolios and about their group structure. Group financial structures are also

beginning to change as the existing complex web of inter locking shareholdings slowly gives way to more transparent ownership patterns. Consolidation of accounts (which is mandatory for accounting periods beginning on or after April 1, 2001) companies can no longer hide the true state of affairs behind a complex web of subsidiaries.

Working capital management

Working capital management has been impacted by a number of the developments discussed above - operational reforms in the area of credit assessment and delivery, interest rate deregulation, changes in the competitive structure of the banking and credit systems, and the emergence of money and debt markets. Companies have found their creditworthiness under greater scrutiny than ever before. But top-notch corporate borrowers have benefited from money market borrowing options and other choices. The greater concern for interest rate risk has made choice of debt maturity more important than before. Cash management has become an important task with the phasing out of the cash credit system.

Investor expectations

A decade of reforms has changed several investor expectations, but some expectations have not changed and have now become anachronistic. These unrealistic expectations are a major stumbling block in financial sector reforms. Understanding and correcting them is critical to the success of the reforms.

Repression and inflation expectations

Prior to the reforms, the bank deposit rate was repressed to the extent of about 3% as estimated above. Over extended periods of time, the Indian investor had got accustomed to the idea that safe interest rates in the official market are repressed and that significantly better rates are available in the unofficial market without significant risk. With the end of financial repression in the early-mid 1990s, this perception would perhaps have been broken if official interest rates had risen sharply to signal a decisive break with the past. This did not happen. The end of financial repression coincided with a sharp fall in inflationary expectations, and nominal interest rates fell as financial repression was lifted. Investors do not therefore fully realised that the repression discount that was embedded in bank deposit rates in the past no longer exists.

Distrust of equities

Except for the eight golden years described earlier in this paper, the performance of equities in India has been very poor. Except for 1984-1992, equities have historically delivered very little capital appreciation during extended periods of time.

Changing the Expectations

The key stumbling block, therefore, is that many investors are neither willing to accept the low rate of return available on fixed income investments nor willing to take the higher risk that goes with equities. At one level, we can dismiss these expectations as unrealistic and inconsistent with the risk return tradeoff that is the bedrock of modern finance. On the other hand, these expectation are real and changing them is important for the healthy development of the capital market.

- The existing flawed expectations leave investors vulnerable to various kinds of frauds and get-rich-quick schemes.
- They also account for the great allure of assured return mutual funds. These mutual funds guarantee a minimum return that is comparable to or superior to bank deposits, but promise significant upside from the small part of the portfolio that is allocated to equities. The mutual fund needs to hedge its risks well and price the implicit put option correctly. Otherwise, it could end up taking huge losses as has happened in India.
- These flawed expectations are also the major obstacle to the reforms of the small savings system that offers administered interest rates that are too high relative to the free market.

The Unfinished Agenda

Throughout this paper, references have been made to the reforms that remain incomplete. The most important and urgent task that remains to be done is that of dismantling the structural and micro regulations that have accumulated over several decades of a command economy. It is also necessary to make the financial sector more competitive to realise efficiency gains, and to ensure that that consumers receive the benefits of lower costs, better costs and greater choices.

Banking Sector

Some of the major steps that need to be taken on the banking sector include the following:

- The banking system must be made more competitive by removing all structural barriers to competition. Unnecessary structural barriers between banks, financial institutions and investment institutions must be eliminated. It is necessary to withdraw regulatory support to cartels like the Indian Banks Association (IBA). Complete branch delicensing should be introduced and banks must be allowed to open, close, swap or sell branches. The logic of deposit deregulation should be carried further with freedom to fix deposit rates on a branch wise basis. This would allow the older large banks to match the new private banks in the highly competitive urban market without necessarily raising rates in the high cost rural branches.
- Now that the privatization of management advocated by the first Narasimham Committee (Ministry of Finance, 1991) has proved to be a myth, it is necessary to move swiftly to privatization of ownership. A pre-requisite for this would be a cleaning up of the balance sheet and possible recapitalisation.

- The pressing problems of the financial institutions need to be addressed by radical restructuring, downsizing of the balance sheet, recapitalisation and eventual privatisation.
- All quantitative credit controls and measures related to directed credit should be withdrawn.
- The payment system must be modernised rapidly by the rapid adoption of technology.

Capital Market

In the capital market, the important measures that are needed include the following:

- Short sale restrictions must be removed completely for all players including the institutions. This is the best defence against market manipulation.
- The problems that have arisen from the lack of an effective listing authority for many stocks need to be addressed. The time has come to consider the establishment of a National Listing Authority on the lines of the similar entity in the United Kingdom.
- To achieve genuine investor protection, we must empower the investors. The goal should be to create a statutory framework under which violation of any SEBI regulation or listing requirement gives the investor the statutory right to sue the company and its management. We could try to replicate the US class action model here or we could try to adapt the PIL (public interest litigation) mechanism that the Indian judiciary has used very effectively. What is needed is a statutory sanction for a process in which investors can enforce their rights against companies without the intervention of the regulators at all.
- Surveillance systems need to make aggressive use of information technology and rely on greater transparency and public disclosure.
- The regulators must adopt a more aggressive pro-competitive policy in an environment in which the securities industry is threatening to become significantly less competitive than in the past (Varma 2001).
- The regulatory climate must become more friendly to hostile takeovers.
- An effective and competitive securities lending system needs to be put in place.
- It is necessary to broad base the derivative markets by allowing foreign and domestic institutions to operate more freely in this market.

Debt and Foreign Exchange Markets

In the field of fixed income and foreign exchange markets, the following issues are important:

- The vulnerabilities associated with the current partial opening up of the capital account need to be addressed.
- The conduct of monetary policy and exchange rate policy needs to take less market distorting forms and needs to display greater sensitivity to the goal of orderly markets.

The Real Economy

Finally, it must not be forgotten that, in the ultimate analysis, a strong financial sector is built on a strong economy. Real sector reforms (for example in the field of bankruptcy law) are very important. Similarly, an essential precondition for the

success of the entire financial reforms program is the maintenance of macroeconomic stability. The large fiscal deficit is, therefore, a grave threat to the long-term success of the financial reforms. The dynamism of the reform process that was lost in the mid-1990s needs to be recaptured to satisfy the aspirations of the Indian people for a vibrant modern economy with a strong and efficient financial sector.

LESSON 4
NON-BANKING FINANCIAL COMPANIES (NBFC)

LESSON OBJECTIVES : TO UNDERSTAND THE CONCEPT OF NBFC, THEIR CLASSIFICATIONS, AND RBI NORMS FOR NBFCS.

INTRODUCTION:

As you already know, financial services sector consists of various types of institutions, among them Non-banking financial companies are very important. NBFCs are financial intermediaries engaged primarily in the business of accepting deposits and delivering credit. They play an important role in channelising the scarce financial resources to capital formation. NBFCs supplement the role of banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers.

Since NBFCs have a more flexible structure as compared to banks, they take quick decisions, assume greater risks and tailor-make their services and charges according to the needs of the clients. They broaden the range of financial services. These are partly fund based and partly fee based.
In clause (b) of the Section 45-I of the Chapter IIIB of the RBI Act, 1934 as

(i) a financial institution which is a company
(ii) a non-banking institution, which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner;
(iii) such other non-banking institutions or class of such institutions, as the bank may with the previous approval of the central government and by notification in the official gazette specify.

NBFC has also been defined as “a non-banking financial company, which is a loan company or an investment company or a hire purchase company or an equipment leasing company or a mutual benefit finance company”.

NBFCs provide a wide range of services such as hire purchase, equipment lease finance, loans, and investments. Due to rapid growth of NBFCs and a wide variety of services provided by them, there has been a gradual blurring of distinction between banks and NBFCs except that commercial banks have the exclusive privilege in the issuance of cheque. All NBFCs are under direct control of RBI in India.

NBFCs can be classified into different segments depending on the type of activities they undertake :

(i) Hire purchase finance company
(ii) Investment company including primary dealers
(iii) Loan company
(iv) Mutual benefit financial company
(iv) Equipment leasing company
(v) Chit fund company
(v) Miscellaneous non-banking companies.

The above mentioned entities are either partially or wholly regulated by the RBI. Before we proceed forward let's understand few terms as these are important for further learning.
Deposits: Definition of the *deposit* is in its broadest sense to include any receipt of money by way of deposit or loan or in any other form. The term excludes following receipts:

(i) Amount received from bank.
(ii) Amount received from development/ State financial corporation or any other financial institution,
(iii) Amount received in the ordinary course of business by way of security deposit, dealership deposit, earnest money, advance against order for goods/properties and services.
(iv) Amount received by way of subscription in respect of a chit and
(v) Loan from Mutual Funds.

Financial Institutions : These mean any non-banking institution / financial companies engaged in any of the following activities :

(i) Financing by way of loans, advances and so on any activity except of its own.
(ii) Acquisition of shares/ stocks/ bonds/ debentures/ securities.
(iii) Hire purchase.
(iv) Any class of insurance, stock-broking etc.
(v) Chit-funds and
(vi) Collection of money by way of subscription/ sale or units or other instruments/ any other manner and their disbursement.

Now let us discuss various types of NBFCs.
Equipment Leasing Company: This means the company which is a financial institution carrying on the activity of leasing (or lease financing) of equipments as its principal (main) business.
Hire Purchase Finance Company: It is a company which is a financial institution carrying on as its principal activity hire purchase transactions or the financing of such transactions.
Investment Company: It means a company which is a financial institution carrying on as its principal business the acquisition of securities.

Loan Company: It means any company which is a financial institution carrying on the as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own.
Mutual Benefit Finance Company (MBFC) : MBFC (also called Nidhis) are NBFCs notified under section 620A of the Companies Act, 1956, and primarily regulated by

Department of Company Affairs (DCA) under the directions/ guidelines issued by them under section 637A of the Companies Act, 1956. These companies are exempt from the core provision of the RBI Act and NBFC directions relating to acceptance of public deposits. However, RBI is empowered to issue direction in matters relating to deposit acceptance activities and directions relating to ceiling on interest rate. They are also required maintain register of deposits, furnish receipt to depositors and submit returns to the RBI.

Regulatory Non-Banking Companies (RNBC) : RNBCs are a class of NBFCs that cannot be classified as equipment leasing company, hire purchase, loan, investment, *nidhi* or chit fund companies, but which tap public savings by operating various deposit schemes, akin to recurring deposit schemes of Banks. The deposit acceptance activities of these companies are governed by the provisions of Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. To safeguard the interest of depositors, the RBI has directed RNBCs to invest not less than 80% of aggregate deposit liabilities as per the investment pattern prescribed by it. They can invest only 20% of aggregate liabilities or 10 times of its net worth, whichever is lower, in a manner decided by its BOD.

The RNBCs are the only class of NBFCs for which, floor rate of interest is specified by the RBI, while there is no upper limit prescribed for them. RBI has also prescribed prudential norms for RNBCs, compliance with which is mandatory and prerequisite for acceptance of deposits.
Miscellaneous Non-Banking Companies: MNBCs are companies engaged in the chit fund business. The term 'deposit' as defined under section 45I(bb) of the RBI Act, 1934, does not include subscription to chit funds. The chit fund companies are exempted from all the core provisions of the Chapter IIIB of the RBI Act. RBI only controls the deposits accepted by these companies, whereas, administration is regulated by the respective state governments.

Growth of NBFCs: NBFCs in India existed since long. They came into limelight in the second half of the eighties and first half of nineties. NBFCs play an important role in funds mobilization in India. Following RBI data shows their role in funds mobilization.

Aggregate Deposits of Non-Banking Companies
(Rupees crore)

Year	Non-bank Financial Companies			Non-bank Non-Financial Companies			Grand Total		
	Regulated Deposits	Exempted Deposits	Total (2 + 3)	Regulated Deposits	Exempted Deposits	Total (5 + 6)	Regulated Deposits	Exempted Deposits	Total (8 + 9)

							(2 + 5)	(3 + 6)	
1	2	3	4	5	6	7	8	9	10
1970-71	41.9	107.8	149.7	189.8	229.2	419.0	231.7	337.0	568.7
1971-72	64.7	146.3	211.0	354.7	126.1	480.8	419.4	272.4	691.8
1972-73	54.3	176.1	230.4	319.4	198.0	517.4	373.7	374.1	747.8
1973-74	80.0	224.0	304.0	403.7	320.9	724.6	483.7	544.9	1028.6
1974-75	104.7	337.7	442.4	393.6	360.7	754.3	498.3	698.4	1196.7
1975-76	128.7	332.8	461.5	416.2	387.5	803.7	544.9	720.3	1265.2
1976-77	147.3	549.0	696.3	572.8	465.8	1038.6	720.1	1014.8	1734.9
1977-78	185.1	564.4	749.5	685.5	627.5	1313.0	870.6	1191.9	2062.5
1978-79	155.6	882.9	1038.5	846.6	751.0	1597.6	1002.2	1633.9	2636.1
1979-80	187.3	1425.3	1612.6	884.6	956.4	1841.0	1071.9	2381.7	3453.6
1980-81	215.0	1260.7	1475.7	1142.3	1570.0	2712.3	1357.3	2830.7	4188.0
1981-82	214.0	1531.6	1745.6	1305.7	2440.5	3746.2	1519.7	3972.1	5491.8
1982-83	237.3	2192.9	2430.2	1740.2	5023.9	6764.1	1977.5	7216.8	9194.3
1983-84	275.6	2885.7	3161.3	2058.9	5903.9	7962.8	2334.5	8789.6	11124.1
1984-85	409.5	3946.5	4356.0	2405.8	9378.6	11784.4	2815.3	13325.1	16140.4
1985-86	485.5	4474.1	4959.6	2781.0	10331.5	13112.5	3266.5	14805.6	18072.1
1986-87	832.3	5109.3	5941.6	3244.5	12214.1	15458.6	4076.8	17323.4	21400.2
1987-88	1136.9	6362.8	7499.7	3598.1	13106.5	16704.6	4735.0	19469.3	24204.3
1988-89	1505.9	8979.0	10484.9	3901.2	14218.8	18120.0	5407.1	23197.8	28604.9
1989-90	1773.4	12869.6	14643.0	4223.7	17215.3	21439.0	5997.1	30084.9	36082.0
1990-91	2040.7	15195.5	17236.2	4706.2	22131.1	26837.3	6746.9	37326.6	44073.5
1991-92	2824.1	17614.4	20438.5	4672.4	26073.9	30746.3	7496.5	43688.3	51184.8
1992-93	4287.8	40668.6	44956.4	4890.1	98250.9	103141.0	9177.9	138919.5	148097.4
1993-94	17389.5	39047.9	56437.4	5812.9	123530.4	129343.3	23202.4	162578.3	185780.7
1994-95	25440.5	60054.6	85495.1	7260.7	151250.5	158511.2	32701.2	211305.1	244006.3
1995-96	38710.6	62961.8	101672.4	8040.1	178869.1	186909.2	46750.7	241830.9	288581.6
1996-97 P	53116.0	71253.7	124369.7	9592.0	214281.1	223873.1	62708.0	285534.8	348242.8

Deposits Mobilized by the NBFC Sector

(Rupees crore)

Year (end-March)	NBFCs No of Reporting Companies	NBFCs Public Deposits	RNBCs No of reporting Companies	RNBCs Public Deposits	NBFC Sector (3+5) Total Public Deposits
1	2	3	4	5	6
1998	1420	13571.73	9	10248.72	23820.45
1999P	1536	9784.66	11	10644.27	20428.93
2000P	996	8337.95	9	11003.77	19341.72

P : Provisional.

Note : 1. Data format has been changed after 1996-97 due to new reporting format

Following changes in the regulatory framework in 1998.
2. The figures reported for 1998, 1999 and 2000 are end-March figures.
Source : RBI Bulletin, Various Issues. www.rbi.org.in

RBI ACT FRAMEWORK:

Introduction: In the 1960s, the RBI made an attempt to regulate the NBFCs by issuing directions relating to the maximum amount of deposits, the period of deposits and rate of interest they could offer on the deposits accepted. Norms were laid down regarding maintenance of certain percentage of liquid assets, creation of reserve funds and transfer thereto every year a certain percentage of profit and so on. To protect the interest of depositors, these directions and norms were revised and amended from time to time.

In the year 1977, the RBI issued two separate sets of guidelines, namely (i) NBFC Acceptance of Deposits Directions, 1977 and (ii) MNBD Directions, 1977 for MNBCs. In 1997, the RBI Act was amended and the RBI was given comprehensive powers to regulate NBFCs. The amended Act made it mandatory for every NBFC to obtain a certificate of registration and have minimum net owned funds. Ceilings were prescribed for acceptance of deposits, capital adequacy, credit rating and net owned funds. This is the only sector which had number of committees trying to regulate its working. The first was the Shah Committee in 1992, followed by the Shere Committee, Khanna Committee and various committees of the RBI.

Based on the report of the Task Force headed by Shri C. M. Vasudev submitted in 1998, the Govt. of India framed Financial Companies Regulation Bill, 2000, to implement the recommendations requiring statutory changes as also consolidate the law relating to NBFC and unincorporated bodies with a view to ensuring depositor protection. The regulations and directions related to NBFCs are divided into following categories:

(vii) Regulatory norms (under chapter IIIB and IIIC).
(viii) RBI Acceptance of Public Deposits Directions.
(ix) RBI NBFCs Prudential Norms Directions.
(x) RBI NBFCs Auditors Report Directions.

Now let's discuss these provisions and regulations in detail for complete understanding of the NBFCs.

REGULATORY NORMS (UNDER CHAPTER IIIB AND IIIC).

First we discuss regulatory norms under chapter IIIB.
Certificate of Registrations: With effect from January, 1997, in order to commence (new company)/ carry on (existing company) the business of a Non-banking financial institution, and NBFC must obtain a certificate of Registration from RBI. The prerequisite for eligibility for such a CoR is that the NBFC should have a minimum Net Owned Fund (NOF) of Rs. 25 Lakh (which has been raised to Rs. 2 Crore from April 21, 1999 for any new applicant).

The RBI, while considering an application for registration, would consider that the NBFC fulfils the following conditions (u/s 45-IA of the RBI Act) :

- The NBFC is/ would be in a position to pay its present/ future depositors in full as and when their claims accrue.
- Its affairs are not being/ likely to be conducted in a manner detrimental to the interests of its present/ future depositors.
- The general character of the management/ proposed management would not be prejudicial to the public interest/ interest of the depositors.
- It has adequate capital structure and earning prospects.
- The public interest would be served by the grant of the certificate to commence/ carry on business in India.
- Grant of the COR would not be prejudicial to the operations/ consolidation of the financial sector consistent with the monetary stability and economic growth considering such other relevant factors specified by the RBI.
- Any other condition fulfillment of which, in the opinion of RBI, would be necessary to ensure that the commencement/ carrying on business in India would not be prejudice to the public interest or the interest of the depositors.
- The RBI may impose conditions while granting registration.

Cancellation of Registration: RBI may cancel COR, if the NBFC:

- Ceases to carry on the business in India.
- Has failed to comply with any condition subject to which the certificate was issued.
- At any time fails to fulfill any of the above conditions which the RBI considered while granting registration.
- Fails to (a) comply with any directions issued by the RBI under the provisions relating to registration, (b) maintain accounts in accordance with the requirements of any law/ directions/ order issued by the RBI under these provisions and (c) submit/ offer for inspection its books of accounts/ other relevant documents when so demanded by an inspecting authority of the RBI, and
- Has been prohibited from accepting deposits by an order of the RBI under those provisions which have been in force for a period of a least three months.

Net Owned Funds : NOF mean (a) paid up capital and free reserves as per the latest balance sheet minus the accumulated losses, if any, deferred revenue expenditure and other intangible assets, and (b) (i) less investment in shares of subsidiaries/ companies in the same group/ all other NBFCs and (ii) the book value of debentures/ bonds/ outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries/ companies in the same group in excess of 10% of (a) above.

Maintenance of Liquid Assets: NBFCs have to invest in *unencumbered approved securities*, valued at a price not exceeding current market price, an amount which at the close of business on any day, shall not be less than 5.0 percent but not exceeding 25.0 percent, specified by RBI, of the deposits outstanding at the close of business on the last working day of the second preceding quarter. The RBI may, however specify different percentages of investment in respect of different classes of NBFCs.

Here *approved securities* mean the securities of any State/Central Govt. and bonds unconditionally guaranteed by them as regards the payment of interest as well as the repayment of principal. These securities are valued at current market price.

Reserve Fund: Every NBFC shall create a reserve fund and transfer thereto a sum not less than 20% of its net profit every year as disclosed in the profit and loss account and before any dividend is declared. Such fund is to be created by every NBFC, irrespective of the fact whether it accepts public deposits or not. Further, no appropriation can be made from the fund for any purpose without the prior written approval of RBI. The Central Govt. may on the recommendation of the RBI, exempt any NBFC for a specified period from the above requirements, having regard to the adequacy of the paid-up capital and reserves in relation to deposit liabilities. But such exemption can be granted only if the reserve fund together with the share premium account of the NBFC is not less than its paid-up capital.

Under Chapter III-B, RBI has comprehensive powers to seek any information from NBFCs, to impose penalties and penal interests in case of any default by NBFCs to provide required information or other default.

Provisions of Chapter III-C is mainly for non-corporate bodies. Non-corporates are not permitted to accept deposits after April 1, 1997. However, individuals can accept deposits from (i) relatives (ii) any other individual for his personal use, but not for lending or business purpose. The non-corporate entities, which hold deposits, should replay it immediately after such deposit becomes due for repayment or within two years from the date of such commencement whichever is earlier. They are prohibited from issuing or causing to be used any advertisement in any form for soliciting deposits.

If certain documents relating to the acceptance of deposits in contravention of the requirements are secreted in any place, a court on application by an authorized officer of the RBI/ State Government may issue a warrant to search for such documents. Such warrants would have the same effect as one issued under the Code of Criminal Procedure.

If a person contravenes any of the above provisions, he would be punishable with imprisonment for a term which may extend to two years or with a fine up to twice the amount of deposit received or Rs. 2000 whichever is more or with both. Generally, the imprisonment and the fine would not be less than one year and Rs. 1000 respectively. A fine exceeding Rs.2000 may be imposed in special circumstances.

RBI ACCEPTANCE OF PUBLIC DEPOSITS DIRECTIONS

The RBI issues directions to regulate acceptance of deposits by NBIs/ FIs. These directions contain provisions regulating the amount/ period of deposits, rates of interest, brokerage etc. They also exempt from their purview certain types of borrowings/ money received by these companies. Main provisions related to deposit acceptance are as under.

on quantum of public deposits: The RBI prescribes how much deposits an NBFC can accept, depending upon the nature of business, NOF and credit rating given the NBFC. At present following norms are applicable:

(i) Loan and investment companies : If the company has NOF of Rs. 25 Lakh, minimum investment grade (MIG) credit rating, complies with all the prudential norms and has CRAR of 15 percent – 1.56 times of NOF

(ii) Equipment leasing and hire purchase finance companies : If company has NOF of Rs. 25 Lakh and complies with all the prudential norms (a) with MIG credit rating and 12% CRAR – 4 times of NOF (b) without MIG credit rating but CRAR 15% or above – 1.5 times of NOF or Rs. 10 crore whichever is less.

Down grading of credit rating: In the event of downgrading of credit rating below the minimum specified investment grade the excess deposit should be regularized in the manner specified. An ELC/HPFC must immediately stop accepting deposits and report the position within 15 days to the RBI and reduce within three years from the date of such downgrading of credit rating the amount of excess public deposit to nil or the appropriate extent permissible to which it is entitled to accept by repayment as and when such deposit falls due or otherwise. A LC/IC must stop immediately accepting the deposits, report to RBI within 15 days and reduce within three years the amount of excess to nil by repayment as and when such deposit fall due or otherwise. In the event of excess public deposit arising out of the regulatory ceiling or downgrading of credit rating, the NBFC may renew the maturing public deposit subject to the compliance of the repayment stipulations and other provisions of these directions. No matured public deposit should be renewed without the voluntary consent of the depositor.

Ceiling of Interest Rates: There was a ceiling of 12.5% per annum on the rate of interest on deposits with effect from November 1, 2001. For RNBCs minimum interest rate is 4% on daily deposits and 6% on other than daily deposits. It may be paid or compounded at rests not shorter than monthly rests. (Check RBI web site for latest ceiling).

Period of Deposits: All the NBFCs cannot accept demand deposits. For other deposits periods are (i) NBFC – 12 to 60 months (ii) RNBCs – 12 to 84 months and (iii) MNBCs (chit funds) – 6 to 36 months.

Payment of brokerage: The permissible brokerage, commission, incentives or any other benefit on deposits with all NBFCs is 2% of the deposit. The expenses by way of reimbursement on the basis of related vouchers/ bills produced up to 0.5 % of the deposits are also permitted.

Renewal of deposits : The NBFCs can permit the existing depositors to renew their deposits before maturity to avail of the benefit of a higher rate of interest provided (i) the deposit is renewed in accordance with the other provisions of these directions and for a longer duration than the remaining period of the original contract and (ii) the interest on the expired period of the deposit is reduced by 1 percent from the rate which the NBFC would have ordinarily paid had the deposit been accepted for the period for which it has run; any interest paid earlier in excess of such reduced rate is recovered/ adjusted. In this context, a depositor means any person who has made a deposit with a company; or a heir, legal representative, administrator or assignee of the depositor.

Advertisements and statements in lieu of advertisement: All NBFCs have to mandatorily comply with the provisions of the NBFC/MNBC Advertisement Rules, 1977. They also should specify in every advertisement the following:

(i) Actual rate of return by way of interest, premium, bonus and other advantages to the depositors.

(ii) Mode of repayment of deposit.

(iii) Maturity period of deposit

(iv) Interest payable on deposits

(v) Rate of interest payable on withdrawal of the deposits

(vi) Terms and conditions for the renewal of deposits

(vii) Any other special feature relating to the terms and conditions for the acceptance/ renewal of deposits and

(viii) The information relating to the aggregate dues (including the non-fund bases facilities provided to) from companies in the same group or other entities/ business venture in which directors and or the NBFC are holding substantial interest and the total amount of exposure to such companies.

Where a NBFC intends to accept deposits without inviting such deposits, it has to file a statement in lieu of the advertisement with the RBI containing all the particulars specified above and duly signed in the specified manner. Such a statement is valid for six months. Fresh statements would have to be delivered in each succeeding year before accepting public deposit in that financial year.

Repayment of deposits: The directions do not permit premature withdrawal of deposits within three months from the date of acceptance. The NBFCs are required to pay interest on withdrawal before maturity at the request of the depositor at the specified rates, namely (i) no interest on withdrawal between three and six months, (ii) not more than 10% p.a. between 6-12 months and (iii) 1% less than the contracted rate on withdrawals after 12 months but before maturity. In case of MNBCs, the interest on such withdrawals is nil between 3-6 months and 1% less than the contracted rate after 6 months but before maturity. The RNBCs can deduct 2% from the rate, which they would have normally paid to the depositors upon maturity, on withdrawal after one year but before expiry of the period of deposit.

In the event of death of depositor, the deposit can be repaid prematurely to the surviving depositor(s) in the case of joint holding with survivor clause, or to the nominee or to the legal heirs with interest at the contracted rate up to the date of repayment. Moreover, a loan can be granted to a depositor after the expiry of three months from the date of deposit at a rate of interest 2% above the contracted rate in the deposit by NBFC up to 75% of the amount of deposit and up to 70% by MNBC.

Maintenance of liquid assets : Under section 451 B, the RBI has specified that the NBFCs holding public deposits should maintain minimum liquid assets in the form of unencumbered approved securities at 15% of public deposits with effect from April 1, 1999. In the case of RNBCs, a sum not less than the aggregate amount of their

liabilities to the depositor is to be held by them as specified investment. The RNBCs are required to submit a certificate from an auditor to this effect every six months, that is, on June 30 and December 31. The aggregate amount of liabilities means the total deposits received together with interest/premium/bonus, accrued on the amount of deposits according to the terms of contract. The directions stipulate that the RNBCs should deploy their funds in such a way that, of their aggregate liabilities:

(i) Not less than 10% in fixed deposits in public sector banks, which can be withdrawn only for repayment of deposits.
(ii) Not less than 70% is held in the form of unencumbered approved securities valued at market value, of which not less than 10% is in securities of the Central / State governments / Government guaranteed bonds, and
(iii) Not more than 20% or ten times the net owned funds of the RNBC, whichever is lower, is in other safe investment approved by the board of directors.

Safe custody of Approved securities: All NBFCs have to designate one of the scheduled commercial banks as its designated banker in the place where their registered offices are situated, intimate in writing to the RBI and entrust to such bank the unencumbered approved securities required to be maintained by it in pursuance to Section 451B of the RBI Act. Alternatively, NBFC may entrust such securities to Stock Holding Corporation of India Ltd, with the prior approval of RBI, subject to conditions as RBI may specify.

LESSON 5
NON-BANKING FINANCIAL COMPANIES (NBFC)

Pursuant to the recommendations of the *Narsimham* Committee and Shah committee, the RBI had prescribed with effect from April, 1993, prudential norms for all types of financial companies with NOF of Rs. 50 Lakh and above, which had to be compulsorily registered with it. In the public interest and to regulate the credit system to the advantage of the country, in exercise of the powers conferred by section 45 JA of the amended RBI Act, the RBI issued directions w.e.f. January 31, 1998; NBFCs Prudential Norms Directions, 1998. These provisions for directions apply to all NBFCs excluding MBFCs with a NOF of Rs. 25 Lakh and above and accepting/holding public deposits.

These norms can be divided into two categories : (i) norms applicable to only those NBFCs which are accepting / holding public deposits and (ii) norms applicable to all NBFCs, irrespective of whether they accept / hold public deposits or not. Let us discuss both the norms one by one.

Prudential norms applicable to only those NBFCs which accept/hold public deposits: These norms are mainly concerned with safety of public funds.

1. Capital to Risk Assets Ratio (CRAR) : The NBFCs holding/accepting public deposits are required to maintain CRAR as under -

(i) EL/HPF companies with MIG credit rating	- 12 percent
(ii) EL/HPF companies without MIG credit rating	- 15 percent
(iii) Loan/Investment companies	- 15 percent
(iv) RNBCs	- 12 percent

CRAR comprises of tier I and tier II capital, to be maintained on a daily basis and not merely on the reporting dates. Tier I capital consists of NOF (core capital) but includes compulsorily convertible preference shares as a special case for CRAR purpose. Tier II capital is all quasi capital like preference shares (other than CCPS), subordinated debt, convertible debentures and so on. Tier II capital should not exceed Tier I capital. General provisions and loss reserves not to exceed 1.25 percent of the risk weighted assets. Subordinated debt is issued with original tenure of 60 months or more.

Restrictive Norms : If a company does not comply fully with the prudential norms it is not allowed to accept/hold public deposits. If any NBFC defaults in repayment of matured deposits, it is prohibited from creating any further assets until the defaults are rectified. NBFCs cannot invest more than 10% of owned funds in real estate (except for its own use). They are also restricted to invest in unquoted shares to following extent (i) EL/HPF companies 10% of NOF and (ii) LC/ICs 20% of NOF.

Concentration of Credit/ Investments : The NBFCs accepting/holding public deposits cannot lend to any single borrower and single group of borrowers in excess of 15 and 25 percent of their owned funds respectively. The ceiling on investment in shares of another company and a single group of company is the same. The permissible ceiling

on loans and investments taken together is 25% to a single party and 40% to single group of parties. For determining these limits, off-balance sheet exposure should be converted into credit risk by applying the appropriate conversion factors. The investments in debentures should be treated as credit and not investment for the purpose of determining the concentration of credit. Moreover, the ceiling on credit/ investment would be applicable to the own group of the NBFCs as well as to the other group of borrowers/investing companies.

The above ceilings on credit/investment concentration are not applicable to RNBCs in respect of investment in approved securities, bonds, debentures and other securities issued by the Government company / public financial institution / bank.

Half yearly returns : NBFCs accepting /holding public deposits must submit their half yearly returns in prescribed format at the end of March and September, every year, within 3 months from the due date. Such returns may or may not be audited, but the figures must be certified by the auditors of the company.

Prudential norms applicable to all NBFCs, irrespective of whether they accept/hold public deposits or not: These norms are mainly concerned with working of the companies.

Income recognition norms : The recognition of income on NPA (non-performing assets) is allowed on cash basis only. The unrealized income recognized earlier is required to be reversed.

NPA norms : Recognition of income on accrual basis before the asset becomes NPA as under : Loans and Advances – up to 6 months and 30 days past due period (past due period done away with effect from March 31, 2003), Lease & HPF – 12 months.
Restrictive norms : NBFCs are not allowed to advance loans/credit against their own shares.

Accounting standards : All the Accounting Standards and Guidance Notes issued by Institute of Chartered Accountants of India (ICAI) are applicable to all NBFCs, in so far as they are not inconsistent with the guidelines of RBI.

Accounting for investments : All NBFCs to have a well defined investment policy. The investments are classified into two categories (i) long-term investments and (ii) current investments. Long-term investments are to be valued as per AS-13 of ICAI. Current investments are further classified into (a) quoted and (b) unquoted.

Current quoted investments are valued at lower of cost or market value. Block valuation permitted for quoted investments, notional gains or losses within the block are permitted to be netted, but not inter-block, net notional gains to be ignored but notional losses to be provided for.

Valuation norms for current unquoted investment are as under :

(a) Equity shares – at lower of cost or break up value or fair value.

(b) Rs. 1 for the entire block of holding if the balance sheet of the investee company is not available for last two years.
(c) Preference shares at lower of cost or face value
(d) Government securities at carrying cost
(e) Mutual fund units at net asset value (NAV) for each scheme and
(f) Commercial Paper (CP) at its carrying cost.

Asset classification : The NBFCs are required to classify all forms of credit (including receivables) to be classified into four categories, i.e. (i) Standard (ii) Sub-standard (iii) Doubtful and (iv) Loss asset.

Standard Asset : An asset in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problems nor carry more than normal risk attached to the business.
Sub-standard Asset : Sub standard asset is one (i) which has been classified as NPA for a period not exceeding two years, (ii) where the terms of the agreement regarding interest and/or principal have been renegotiated or rescheduled after the commencement of operations until the expiry of one year of satisfactory performance under the renegotiated/ rescheduled terms.

Doubtful Asset : A doubtful asset means term loan/ leased asset/ hire-purchase asset/ any other asset which remains sub-standard asset for a period exceeding two years.

Loss Asset : A loss asset is one where loss has been identified by the NBFC or internal or external auditors or the RBI inspection to the extent the amount has not been written off, wholly. Alternatively, it may be an asset which is adversely affected by a potential threat of non-recoverability due to, either erosion in the value of the security/ non-availability of security or any fraudulent act/ omission on the part of the borrower.

Provisions for NPA – Loans and Advances : All NBFCs are required to provide for various assets as following :

Sub standard assets :	10% of outstanding balance
Doubtful assets :	20% (doubtful up to 1 year) of O/s balance
	30% (doubtful 1 to 3 years)
	50% (doubtful more than 3 years)
Loss Assets :	100% of the outstanding balance

Provision for NPA : EL & HP : Unsecured portion to be fully provided for. Further provision on net book value (NBV) of EL/HP assets. Accelerated additional provisions against NPAs as per following rates :

NPA for 1 to 2 years	10% of NBV
NPA for 2 to 3 years	40% of NBV
NPA for 3 to 4 years	70% of NBV
NPA for more than 4 years	100% of NBV

Value of any other security considered only against additional provisions.

Rescheduling in any manner will not upgrade the asset up to 12 months of satisfactory performance under the new terms. Repossessed assets to be treated in the same category of NPA or own assets option lies with the company.

Risk-weights and credit conversion factors : Risk-weights to be applied to all assets except intangible assets. Risk-weights to be applied after netting off the provisions held against relative assets. Risk weights are 0, 20 and 100. Assets deducted from owned fund like exposure to subsidiaries or companies in the same group or intangible to be assigned 0 per cent risk weight. Exposures to all-India financial institutions at 20% risk weighted and all other assets to attract 100% risk weights. Off-balance sheet items to be factored at 50 or 100 and then converted for risk weight.

Disclosure requirements :

(i) Every NBFC is required to separately disclose in its balance-sheet the provisions made as outlined above without netting them from the income or against the value of asset.

(ii) The provisions shall be distinctly indicated under separate heads of accounts as under
   (a) Provisions for bad and doubtful assets and
   (b) Provisions for depreciation in investments.

(iii) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC

(iv) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general provisions and loss reserves may be written back without making adjustment against them.

Supervision : In order to ensure that NBFCs function on sound lines and avoid excessive risk taking, the RBI has developed a four pronged supervisory framework based on :

(i) On-site inspection structured on the basis of assessment and evaluation of CAMELS (Capital, Assets, Management, Earnings, Liquidity and Systems) approach.

(ii) Off-site monitoring supported by state-of-art technology. It is through periodic control reports from NBFCs.

(iii) Use of Market Intelligence System.

(iv) Exception reports of statutory auditors of NBFCs.

The RBI supervises companies not holding public deposits in a limited manner. Companies with asset size of Rs. 100 crore and above are subject to annual inspection while other non-public deposit companies are supervised by rotation one in every five years.

RBI NBFCS AUDITORS' REPORT DIRECTIONS

Now lets us discuss the Directions given by RBI related to Auditors Report. W.e.f. January 31, 1998, RBI has given directions to statutory auditors report, which is applicable to all auditors of NBFCs. The main requirements of the directions are as described below.

Matters Included in Auditor's Report : In addition to the normal auditors report u/s 277 of the Companies Act, on the financial statements of NBFCs to the shareholders, the auditors should also make a separate report to the Board of Directors of the NBFCs containing statements on matters of supervisory concern to the RBI detailed below.

In case of All NBFCs : The auditors have to report whether the NBFC :

- Has applied for registration with the RBI
- Is incorporated before January 9, 1997.
- Has received any communication about grant/refusal of COR and
- Has obtained a COR of incorporation on/after January 9, 1997.

In case of NBFCs Accepting / Holding Public Deposits : The directors are directed to include a statement on the following :

- The public deposits accepted by the NBFC together with other borrowings, namely, issue of unsecured non-convertible debentures/bonds to public, from shareholders and any other deposit not excluded from the definition of the NBFCs Acceptance of Public Deposits Directions, 1998 are within the limits admissible under the provisions of these directions.
- The credit rating for fixed deposits assigned by the rating agency on the specified date is in force, and the aggregate amount of the outstanding deposits at any point of time during the year has exceeded the limit specified by the rating agency.
- The NBFC has defaulted in paying to its depositors the interest and/or principal amount of the deposits after such interest and/or principal became due.
- The NBFC has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts and concentration of credit/investments as specified by the NBFCs Prudential Norms Directions, 1998.
- The CAR as disclosed in the return submitted to the RBI in terms of RBI Prudential Norms Directions, 1998 has been correctly determined and such ratio is in conformity / compliance with the minimum CRAR prescribed by the RBI.
- The NBFC has complied with the liquidity requirements and kept the approved securities with a designated bank.
- The NBFC has furnished to the RBI within the stipulated period the half yearly return on the specified prudential norms and
- The NBFC has furnished to the RBI within the stipulated period the return on deposits as specified in the first schedule to the NBFC Acceptance of Public Deposit Directions, 1998.

In Case of NBFC not Accepting Public Deposits : The auditor's report should also include a statement as to whether (i) The board of directors of the NBFC has passed a resolution for the non-acceptance of any public deposits (ii) the NBFC has accepted any public deposits during the period and (iii) the NBFC has complied with the

prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it.

As regards the IC type of NBFCs which does not accept public deposits and has invest at least 90% of its assets in the securities of its group/holding/subsidiary companies as long term investment, the statement in the auditor's report should mention whether :

(i) The BOD has passed a resolution for the non-acceptance of public deposits.
(ii) The IC has accepted any public deposit during the relevant period/year.
(iii) The NBFC has through a resolution of BOD identified the group/ holding/ subsidiary companies.
(iv) The cost of investment in group/ holding/ subsidiary companies is not less than 90 percent of the cost of the total asset of the NBFC/IC at any point of time throughout the accounting period and
(v) The IC has continued to hold securities of group/ holding/ subsidiary companies as long term investments and has not traded in those investments during the accounting period / year.

So far we have discussed the norms prescribed by RBI related to NBFCs. For latest information you shall visit various websites (i.e. www.rbi.org.in; www.nic.in, etc) and refer to business dailies and magazines (i.e. The Economic Times, Business Standard, Business World, Business Today, etc.)

LESSON 6
LATEST RBI / MINISTRY OF FINANCE GUIDELINES FOR NBFCs

LESSON OBJECTIVES: TO UNDERSTAND THE LATEST REGULATORY NORMS AND RULES FOR NBFCS.

TO LEARN LEGAL RESTRICTIONS ON NBFCS AND LATEST RULINGS BY COURTS IN THIS REGARDS.

This lesson is combination of two activities:

1. A small group of 7-8 students will be made and each group is required to Collect latest RBI / MOF guidelines related to NBFCs,

2. Collect latest court decisions related to NBFC cases. A presentation by each group on their findings.

To achieve the lesson objective you are required to search business magazines, financial dailies and internet (websites of Ministry of Finance, RBI, Supreme Court etc) and prepare an assignment in approx 500 words. You can also contact Financial and Legal advisors in your city / in your contact to collect the information.

Each group shall base the presentation on findings. You are advised to make use of audio visual devices and computers to give an effective presentation.

LESSON 7

TUTORIAL

LESSON OBJECTIVES : TO HELP CLEAR ALL DOUBTS AND DIFFICULTIES ON THE TOPICS SO FAR COVERED.

TO PROVIDE THE STUDENTS EXTRA INPUT IN FORM DISCUSSION AND PROBLEM SOLVING.

To achieve the lesson objective, you are advised to come prepared with all your problems, doubts and difficulties on the topics discussed so far and an open discussion will be conducted so that the faculty as well as your classmates clears all your doubts.

FOR REFERENCE FOLLOWING ARE ARTICLES FROM JOURNALS AND INTERNET.

www.indiamark.com

INVESTMENT IN INDIA - BANKING - FINANCIAL SECTOR & BANKING

Financial sector and Banking:
Continuing reforms in the banking sector were aimed at improving the efficiency and financial strength of commercial banks. Aggregate deposits of the scheduled commercial banks stood at $ 1.48 billion in IFY1997-98, an increase of 15.1 percent.

Net profits of commercial banks
Net profits of scheduled commercial banks rose sharply from $ 24 million in 1995-96 to1.2 billion in 1996-97, an increase of 387 percent. Much of the increase was due to marking government securities to market prices, following significant declines in prevailing interest rates. Three public sector banks received capital restructuring loans from the government totaling $ 68 million in 1997-98, enabling those banks to reach a capital adequacy ratio of 8 percent.

Autonomy package
In November 1997, the Indian government announced an autonomy package for financially stronger public sector banks to help them compete more efficiently in a liberalized environment and to accelerate credit creation. Eleven banks qualified for the autonomy package.

The criteria for administrative autonomy are:
- capital adequacy of at least 8 percent;
- net non-performing assets of less than 9 percent;
- minimum net owned funds of more than $ 2.5 million (Rs 100 crore);

- and a net profit for the last three years.

Banks that meet the four criteria will be given operational freedom in most administrative matters.

RBI norms for NBFC's

The RBI has relaxed its norms for non-bank finance companies (NBFCs) with regard to taking deposits from the public. It has allowed equipment leasing and hire-purchase finance companies with investment-grade ratings to access public deposits, raised the ceiling on the amount of public deposits these NBFCs may accept and extended the deadline for full compliance on its regulations by two years, until December 2000.

The financial viability of many NBFCs continues to be of concern to the government and RBI regulators. There is considerable consolidation activity in this sector as NBFCs adjust to the tougher standards they are being required to meet.

WTO negotiations on financial services:

India made a number of new commitments in the WTO Financial Services agreement concluded in Geneva in December 1997. These modest commitments will come into effect in January 1999.

Major features of India's offer include:

- granting most favored nation (MFN) status to all foreign banks and financial services companies (including insurance),
- dropping a previous MFN exemption on banking;
- granting 12 new bank branch licenses per year to foreign banks (up from the present commitment of 8 per year);
- lifting the 10 percent ceiling on reinsurance by Indian insurance companies;
- allowing 51 percent foreign investment in financial consulting, factoring, leasing, venture capital, merchant banking and non-banking finance companies.

Insurance sector

In addition, 49 percent foreign equity will be allowed in stock brokerages; and foreign financial services companies, including banks, will be allowed to invest venture capital in India up to 51 percent of a company's equity Insurance.

Legality

As part of his 1998-99 budget presentation to Parliament on June 1, the Finance Minister announced his intention to open the insurance sector to competition from Indian private sector companies. He also proposed to convert Insurance Regulatory Authority (IRA) into an independent, statutory body. Both actions will require Parliament to adopt new legislation, including amendments to two Acts which reserve life insurance and general insurance for government owned monopolies.

Foreign insurance companies

The government has not yet clarified whether foreign insurance companies will be allowed to participate as minority joint venture partners when the sector is opened up. Many observers believe that the government will allow foreign participation to compensate for a lack of capital and expertise among likely participants in the Indian private sector.

LIC and GIC

The government has granted substantial operational autonomy to the Life Insurance Corporation (LIC) and General Insurance Corporation (GIC), both of which have monopoly positions in their respective sectors under current law. LIC can now appoint fund managers/investment advisors both in India and abroad and is allowed to invest 60 percent of its insurance funds in approved market investments. New measures also provide more lenient investment norms, permission to trade in securities subject to prescribed limits and more delegation of operational powers to the four general insurance subsidiaries of GIC.

Capital Account Convertibility

The *Tarapore* Committee report on Capital Account Convertibility, released in June 1997, recommended a three-year timeframe for complete capital account convertibility of the rupee. The Committee set out the following preconditions for full convertibility:

- Reduction of the fiscal deficit to 3.5 percent of GDP by 1999-2000;
- An average inflation rate of 3-5 percent for the period 1997-2000;
- Complete deregulation of all interest rates in 1997-98;
- Reduction in the level of banks' NPAs from an estimated 13.7% of total loans in March'97 (actual NPAs were 17.8% of total loans) to 5% in 1999-2000; and
- A reduction in the cash reserve ratio (CRR) to about 3 percent;
- The adoption of a transparent exchange rate policy by 2000.

There is a general consensus in government and business community that India should not move to capital account convertibility until these conditions have been met, lest India suffer the kind of currency crisis which hit other Asian countries in 1997.

TOP NBFCS HAVE LESSER COST OF FUNDS THAN BANKS

www.business-standard.com - *Business Standard/ Mumbai April 29, 2004*

Crisil, the rating agency, said cost of funds for highly rated non-banking finance companies (NBFCs) is less than that for banks. This means the historical advantage that banks enjoyed over NBFCs where resources are concerned has gradually diminished. Earlier, NBFCs faced a 182 basis points disadvantage in their funding costs vis-a-vis banks' all-inclusive funding cost of 12.75 per cent.

However, the scenario has reversed now with NBFC enjoying a funding cost benefit of 48 basis points vis-a-vis banks' all-inclusive funding cost of 6.53 per cent. In the past, NBFCs had a significant disadvantage against banks because of the considerable spread that the latter earned on their deployed assets versus their deposits.

The NBFC business model has strengthened considerably over the past few years in terms of their access to varied funding sources. The growth of the mutual fund industry and the emergence of securitisation as a borrowing tool have helped strengthen the NBFC sector.

A break-up of NBFCs sources of funds shows that in FY 2002-03 non convertible debentures & commercial paper accounted for 47 per cent of the total resources raised

as against 39 per cent in FY 1999-2000; fixed deposits — eight per cent (16 per cent); loans from banks and other sources — 45 per cent (unchanged); and securitisation — nine per cent (one per cent). Crisil reasoned that with declining interest rates and falling spreads over G-Sec yields, however, banks funding cost advantage has been wiped out.

This is after factoring in the reduction in the negative carry that banks bear owing to their statutory liquidity ratio and cash reserve ratio investments, which has also fallen because of the decline in opportunity cost of the funds thus deployed, and the operating costs incurred for mobilising their deposits.

"This has contributed in no mean measure in strengthening the business model of these NBFCs," the agency said. In the past, banks have enjoyed an inherent advantage over NBFCs in terms of raising term deposits at relatively lower costs and raising resources through savings and current accounts.

The southward movement in interest rates since FY 1998-99 has had a twofold impact on banks' cost metrics. Not only has the benefit from low-cost current and savings accounts declined but the spreads on their investments in government securities vis-a-vis their cost of term deposits has also declined.

A flavour of numbers for banks' indicates that the cost of term deposits has declined sharply by about 525 basis points since 1999-2000 in line with the declining trend in the yield on G-Secs, while the yield on G-Secs has declined even more by over 650 basis points. The interest on savings accounts has, however, fallen by only 150 basis points in the same period.

Crisil believes that this has reduced the benefit that banks enjoyed by virtue of having access to current and savings accounts by 147 basis points. Of this 94 basis points is because of a reduced benefit from savings accounts while 53 basis points emanates from current accounts.

Banks have also been affected by the higher reduction in yields on the investments in G-Secs vis-a-vis their term deposit costs. Historically, banks enjoyed a positive spread on an incremental basis of about 150 basis points on the yield on their investments in G-Secs (of 8-10 year maturity) over their cost of term deposits (2-3 year maturity).

This spread has been wiped out since the last 18 months, partly because of the high liquidity in money market and partly due to the relatively higher decline in yields on G-Secs over the term deposits. The overall reduction in the banks' gross spreads because of the twin factors of declining interest rates and lower spreads on G-Sec yields is about 297 basis points.

Crisil, however, pointed out that even though the universe of NBFCs rated by it has demonstrated a clear strengthening of their business model, the banking model continues to have several advantages over that of NBFCs. The rating agency believes that a bank's resource base is considerably more stable because of the high proportion of retail deposits in the total funding base.

Moreover, banks have the potential to earn a significant fee income from transaction banking and other services. Banks have cross-selling opportunities to the large retail population that they tap to raise resources.

NBFCS BARRED FROM ACCEPTING NRI DEPOSITS

www.business-standard.com - Business Standard/ Mumbai April 26,2004

In another step to stem dollar inflows into the country, the Reserve Bank of India (RBI) on April 24 barred non banking financial companies (NBFCs) from accepting expatriates' deposits made through fresh remittances from abroad. An RBI statement said entities other than banks have been disallowed from accepting deposits made by expatriates from foreign currency and repatriable rupee accounts.

"They will, however, be permitted to continue to hold the existing deposits and also renew such deposits held in the name of the NRIs (non-resident Indians) on repatriation or non-repatriation basis," it added.

Prior to this directive, a company registered under the Companies Act, 1956, or a body corporate created under an Act of Parliament or State Legislature, and NBFCs were also permitted to collect deposits.

According to market players, the latest central bank move is yet another step aimed at discouraging dollar inflows and to cap the rapid appreciation in the rupee, which has gained by about 3.5 per cent against the dollar in 2004.

According to the latest weekly statistical supplement released by the RBI, the country's foreign exchange reserves in the week ended April 16 rose to $117.592 billion against $116.060 billion in the previous week.

The RBI also stated that NBFCs will not be permitted to accept deposits from NRIs by debit to their non-resident external (NRE) or foreign currency non-resident (bank) (FCNR-(B)) accounts.

However, it added that these entities can accept deposits from NRIs by debit to non-resident ordinary (NRO) accounts, provided that the amount deposited with such entities does not represent inward remittances or transfer from NRE/FCNR(B) accounts into this account.

On April 17, the RBI had extended a ceiling on the rate of interest offered by banks and NBFC's on non resident deposits.

NORMS ON NBFC EXPOSURE TO CORE LOANS ALTERED

www.business-standard.com - Business Standard August 02,2003

The Reserve Bank of India today modified the prudential norms applicable to non-banking finance companies (NBFCs) in relation to their exposure to infrastructure loans. It has also tightened its norms on classification of non-performing assets in the sub-standard assets category.

The RBI has also allowed NBFCs to exceed exposure norms in single party by 5 per cent and for single group of parties by 10 per cent when additional exposure is on account of infrastructure related loans and investments.

The apex bank has also allowed, all investments by NBFCs in AAA rated securitised paper, pertaining to the infrastructure facility, a lesser risk weight of 50 per cent instead of 100 per cent.

The RBI has said that a non-performing asset (NPA) will be classified in sub-standard category for a period of only 18 months, instead of the present norm of 24 months, from the date it is recognised as NPA.
It has also added that the asset will be classified as a a doubtful asset, after an asset has remained in sub-standard category for 18 months, as against the present norm of 24 months. The RBI specified that for the purpose of encouraging NBFCs to grant infrastructure loans, when infrastructure loans granted by NBFCs are restructured or renegotiated or rescheduled before the assets have been classified as sub-standard, they can continue to be classified as standard assets, subject to certain conditions.
RBI has also pointed that the long-term financing of infrastructure projects may lead to asset- liability mismatches, particularly when such financing is not in conformity with the maturity profile of the NBFCs' liabilities.

The NBFCs would, therefore, need to exercise due vigil on their asset-liability position to ensure that they do not run into liquidity mismatches on account of lending to such projects, the RBI added. It also pointed that timely and adequate availability of credit is the pre-requisite for successful implementation of infrastructure projects.
"Multiplicity of appraisals by every institution involved in financing, leading to delays, has to be avoided and the NBFCs should be prepared to broadly accept technical parameters laid down by leading public financial institutions. Also, setting up a mechanism for an ongoing monitoring of the project implementation will ensure that the credit disbursed is utilised for the purpose for which it was sanctioned," said RBI.

LESSON 8

THEORETICAL AND REGULATORY FRAMEWORK OF LEASING

LESSON OBJECTIVES: TO UNDERSTAND THE CONCEPT OF LEASE FINANCING, REGULATIONS RELATED TO LEASING,DOCUMENTATION, TAXATION AND REPORTING OF LEASE.

INTRODUCTION:

Among the various methods of customer credit, lease financing is one of the very important methods. In developing economies it provides a safe mode of financing, where customer gets the equipment he requires, and the financer has the safety through ownership of the equipment. Now let us discuss in detail various aspects of leasing.

Meaning: Lease is a contractual arrangement/ transaction in which a party (lessor) owning an asset/equipment provides the asset for use to another party/ transfer the right to use the equipment to the user (lessee) over a certain/for an agreed period of time for consideration in form of / in return for periodic payments / rental with or without a further payment (premium). At the end of the contract period (lease period) the asset/equipment is returned to the lessor.

It is a method of financing the cost of an asset. It is a contract in which a specific equipment required by the lessee is purchased by the lessor (financier) from a manufacturer / vendor selected by the lessee. The lessee has the possession and use of an asset on payment of the specified rental over a pre-determined time. Lease financing is, thus a device of financing/money lending. The real function of lessor is not renting of asset but lending of funds or financing or extending credit to the borrower.

Main characteristics of lease financing can be explained as following:

Parties to Contract: There are essentially two parties to the contract of leasing i.e. financer (or owner - Lessor) and user (lessee). Also, there could be lease-broker who

works as an intermediary in arranging lease finance deals, in case of exposure to large funds. Apart from above three there are some times lease-financers also, who refinances to the lessor (owner).

Ownership Separated from User: The essence of a lease finance deal is that during the lease-period, the ownership of assets vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.
Lease Rentals: The consideration which the lessee pays to the lessor for the lease transaction is the lease rental. The lease rentals are so structure as to compensate the lessor the investment made in the asset (in the form of depreciation), the interest on the investment, repairs and so forth, borne by the lessor, and servicing chares over the lease period.

Term of lease: The term of lease is the period for which the agreement of lease remains in operations. Every lease should have a definite period otherwise it will be legally inoperative. The lease can be renewed after expiry of the term.
Classification of Lease: A lease contract can be classified on various characteristics in following categories:

A. Finance Lease and Operating Lease
B. Sales & Lease back and Direct Lease
C. Single investor and Leveraged lease
D. Domestic and International lease

Finance Lease: A Finance lease is mainly an agreement for just financing the equipment/asset, through a lease agreement. The owner /lessor transfers to lessee substantially all the risks and rewards incidental to the ownership of the assets (except for the title of the asset). In such leases, the lessor is only a financier and is usually not interested in the assets. These leases are also called "Full Payout Lease" as they enable a lessor to recover his investment in the lease and derive a profit. Finance lease are mainly done for such equipment/assets where its full useful/ economic life is normally utilized by one user – i.e. Ships, aircrafts, wagons etc.

Generally a finance lease agreement comes with an option to transfer of ownership to lessee at the end of the lease period. Normally lease period is the major part of economic life of the asset.

Operating Lease: An operating lease is one in which the lessor does not transfer all risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The operating lease is normally for such assets which can be used by different users without major modification to it. The lessor provides all the services associated with the assets, and the rental includes charges for these services. The lessor is interested in ownership of asset/equipment as it can be lent to various users, during its economic life. Examples of such lease are Earth moving equipments, mobile cranes, computers, automobiles etc.
Sale and Lease Back: In this type of lease, the owner of an equipment/asset sells it to a leasing company (lessor) which leases it back to the owner (lessee).

Direct Lease: In direct lease, the lessee and the owner of the equipment are two different entities. A direct lease can be of two types: Bipartite and Tripartite lease.
Bipartite lease: There are only two parties in this lease transaction, namely (i) Equipment supplier-cum-financer (lessor) and (ii) lessee. The lessor maintains the assets and if necessary, replace it with a similar equipment in working condition.
Tripartite lease: In such lease there are three different parties (i) Equipment supplier (ii) Lessor (financier) and (iii) Lessee. In such leases sometimes the supplier ties up with financiers to provide financing to lessee, as he himself is not in position to do so.
Single investor lease: This is a bipartite lease in which the lessor is solely responsible for financing part. The funds arranged by the lessor (financier) have no recourse to the lessee.

Leveraged lease: This is a different kind of tripartite lease in which the lessor arranges funds from another party linking the lease rentals with the arrangement of funds. In such lease, the equipment is part financed by a third party (normally through debt) and a part of lease rental is directly transferred to such lender towards the payment of interest and installment of principal.

Domestic Lease: A lease transaction is classified as domestic if all the parties to such agreement are domiciled in the same country.
International Lease: If the parties to a lease agreement domiciled in different countries, it is known as international lease. This lease can be further classified as (i) Import lease and (ii) cross border lease.
Import lease: In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country. The lessor imports the assets and leases it to the lessee.
Cross border lease: When the lessor and lessee are domiciled in different countries, it is known as cross border lease. The domicile of asset supplier is immaterial.

ADVANTAGES OF LEASING:

Leasing offers advantages to all the parties associated with the agreement. These advantages can be grouped as (i) Advantages to Lessee (ii) Advantages to lessor.
Advantages to the Lessee: The lease financing offers following advantages to the lessee:

Financing of Capital Goods: Lease financing enables the lessee to have finance for huge investments in land, building, plant & machinery etc., up to 100%, without requiring any immediate down payment.
Additional Sources of Funds: Leasing facilitates the acquisition of equipments/ assets without necessary capital outlay and thus has a competitive advantage of mobilizing the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.
Less costly: Leasing as a method of financing is a less costly method than other alternatives available.

Ownership preserved: Leasing provides finance without diluting the ownership or control of the promoters. As against it, other modes of long-term finance, e.g. equity or debentures, normally dilute the ownership of the promoters.
Avoids conditionality: Lease finance is considered preferable to institutional finance, as in the former case, there are no strings attached. Lease financing is beneficial since it is free from restrictive covenants and conditionality, such as representation on board etc.

Flexibility in structuring rental: The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor made that the lessee is bale to pays the rentals from the funds generated from operations.

Simplicity: A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation.
Tax Benefit: By suitable structuring of lease rentals a lot of tax advantages can be derived. If the lessee is in tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortized faster to than in a case where it is owned by the lessee, since depreciation is allowable at the prescribed rates.

Obsolescence risk is averted: In a lease arrangement the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with latest technology.
Advantage to the Lessor: A lease agreement offers various advantages to lessor as well. Let us discuss those advantages one by one.

Full security: The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset in case of default by the lessee.
Tax benefit: The greatest advantage to the lessor is the tax relief by way of depreciation.

High profitability: The leasing business is highly profitable, since the rate of return is more than what the lessor pays on his borrowings. Also the rate of return is more than in case of lending finance directly.
Trading on equity: The lessor usually carry out their business with high financial leverage, depending more on debt fund rather equity.

High growth potential: The leasing industry has a high growth potential. Lease financing enables the lessee to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital.

LIMITATIONS OF LEASING:

On one hand leasing offers various advantages to both lessor and lessee, but on the other hand it also has some limitations. Now let us try to visualize these limitations.

Restrictions on use of limitations: Under a lease agreement, sometimes restrictions are imposed related to uses, alteration and additions to asset even though it may be essential for the lessee.
Limitations of Financial Lease: A financial lease may entail a higher payout obligations, if the equipment is found not useful and the lessee opts for premature termination of the lease. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.

Loss of Residual Value: The lessee never becomes the owner of the leased asset. Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessee or caused by inflation or otherwise, such as appreciation in value of leasehold land.
Consequences of Default: If the lessee defaults in complying with any terms and conditions of the lease contract, the lessor may terminate the lease and take over the possession of the leased asset. In case of finance lease, the lessee may be required to pay for damages and accelerated rental payments.

Understatement of Lessee's assets: Since the leased asset do not form part of lessee's assets, there is an effective understatement of his assets, which may sometimes lead to gross underestimation of the lessee. However, there is now an accounting practice to disclose the leased assets by way of footnote to the balance sheet.
Double sales tax: With the amendment of sales tax law of various states, a lease financing transaction may be charged to sales-tax twice – once when the lessor purchases the equipment and again when it is leased to the lessee.

REGULATORY FRAMEWORK OF LEASING IN INDIA

As such there is no separate law regulating lease agreements, but it being a contract, the provisions of The Indian Contract Act, 1872 are applicable to all lease contracts. There are certain provisions of law of contract, which are specifically applicable to leasing transactions. Since lease also involves motor vehicles, provisions of the Motor Vehicles Act are also applicable to specific lease agreements. Lease agreements are also subject to Indian Stamp Act.

We will discuss in short main provisions of *The Indian Contract Act, 1872* related to leasing.
Contract: A contract is an agreement enforceable by law. The essential elements of a valid contract are – Legal obligation, lawful consideration, competent parties, free consent and not expressly declared void.
Discharge of Contracts: A contract me by discharged in following ways – By performance, by frustration (impossibility of performance), by mutual agreement, by operation of law and by remission.
Remedies for Breach of Contract: Non-performance of a contract constitutes a breach of contract. When a party to a contract has refused to perform or is disabled from performing his promise, the other party may put an end to the contract on account of breach by the other party. The remedies available to the aggrieved party are – Damages or compensations, specific performance, suit for injunction (restrain from doing an act), suit for *Quantum Meruit* (claim for value of the material used).

Provisions Related to Indemnity and Guarantee: The provisions contained in the Indian Contract Act, 1872 related to indemnity and guarantee are related to lease agreements. Main provisions are as under –

Indemnity: A contract of indemnity is one whereby a person promises to make good the loss caused to him by the conduct of the promisor himself or any third person. For example, a person executes an indemnity bond favoring the lessor thereby agreeing to indemnify him of the loss of rentals, cost and expenses that the lessor may be called upon to incur on account of lease of an asset to the lessee. The person who gives the indemnity is called the 'indemnifier' and the person for whose protection it is given is called the 'indemnity-holder' or 'indemnified'.

In case of lease agreements, there is an implied contact of indemnity, where lessee will have to make good any loss caused to the asset by his conduct or by the act of any other person, during the lease term.

Guarantee: A contract of guarantee is a contract, whether oral or written, to perform the promise or discharge the liability or a third person in case of his default. A contract of guarantee involves three persons – 'surety' who gives guarantee, principal debtor and creditor. A contract of guarantee is a conditional promise by the surety that if the debtor defaults, he shall be liable to the creditor.

Bailment: The provisions of the law of contract relating to bailment are specifically applicable to leasing contracts. In fact, leasing agreement is primarily a bailment agreement, as the main elements of the two types of transactions are similar. They are:

(i) There are minimum two parties to a bailment i.e. bailor – who delivers the goods and bailee – to whom the goods are delivered for use. The lessor and lessee in a lease contract are bailor and bailee respectively.
(ii) There is delivery of possessions/transfer of goods from the bailor to the bailee. The ownership of the goods remains with the bailor.
(iii) The goods in bailment should be transferred for a specific purpose under a contract.
(iv) When the purpose is accomplished the goods are to be returned to the bailor or disposed off according to his directions.

Hence lease agreements are essentially a type of bailment. Following are the main provisions related to lease.

Liabilities of Lessee: A lessee is responsible to take reasonable care of the leased assets. He should not make unauthorized use of the assets. He should return the goods after purpose is accomplished. He should pay the lease rental when due and must insure & repair the goods.

Liabilities of Lessor: A lessor is responsible for delivery of goods to lessee. He should take back the possession of goods when due. He must disclose all defects in the assets before leasing. He must ensure the fitness of goods for proper use.

Remedies for Breach of Contract:

In case of breach of contract various remedies are available to aggrieved party. They are as following:

Remedies to the lessor: The lessor can forfeit the assets and can claim damages in case of breach by lessee. The lessor can take repossession of the assets in case of any breach by the lessee.
Remedies to the lessee: Where the contract is repudiated for lessor's breach of any obligation, the lessee may claim damages for less resulting from termination. The measure of damages is the increased lease rentals (if any) the lessee has to pay on lease of other asset, plus the damages for depriving him from the use of the leased asset from the date of termination of the date of expiry of lease term.
Sub-lease of a Leased Asset: The lessee must not do any act, which is not consistent with the terms of the lease agreement. Lease agreements, generally, expressly exclude the right to sub-lease the leased asset. Thus, one should not sub-lease the leased assets, unless the lease agreement expressly provides.
Effect of sub-lease: The effect of a valid sub-lease is that the sub-lease becomes a lease of the original lessor as well. The sub-lease and the original lessor have the same right and obligations against each other as between any lessee and lessor.
Effect of termination of Main lease: A right to sub-lease is restricted to the operation of the main lease agreement. Thus, termination of the main lease will automatically terminate the sub-lease. This may create complications for sub-lessee.

So far we have discussed the main provisions related to The Indian Contract Act, 1872. Now let us discuss the other laws related to leasing.
Motor Vehicles Act: Under this act, the lessor is regarded as dealer and although the legal ownership vests in the lessor, the lessee is regarded owner as the owner for purposes or registration of the vehicle under the Act and so on. In case of vehicle financed under lease/hire purchase/hypothecation agreement, the lessor is treated as financier.
Indian Stamp Act: The Act requires payment of stamp duty on all instruments/ documents creating a right/ liability in monetary terms. The contracts for equipment leasing are subject to stamp duty, which varies from state to state.
RBI NBFCs Directions: RBI Controls mainly working of Leasing Finance Companies. It does, not in any manner, interfere with the leasing activity.

LEASE DOCUMENTATION AND AGREEMENT
A lease transaction involves a lot of formalities and various documents. The lease agreements have to be properly documented to formalize the deal between the parties and to bind them. Documentation is necessary to overcome any sort of confusion in future. It is also legally required, since it involves payment of stamp duty. Without proper documentation, it will be very difficult to prove your claim in competent court, in case of any dispute.

The essential requirements of documentation of lease agreements are that the person(s) executing the document should have the legal capacity to do so; the documents should be in prescribed format; should be properly stamped, witnessed and the duly executed and stamped documents should be registered, where necessary with appropriate authority.

Now, let us discuss in short, the formalities required.
To, take a decision whether to finance a lease or lease an asset, the lessor/ financier requires a lot of commercial document of the lessee e.g. balance sheet for last 3 years,

MOA & AOA, copies of board resolution etc. After taking a decision to lease / finance the asset, a lease agreement is created. The lease agreement specifies legal rights and obligations of the lessor and lessee. Usually a maser lease agreement is signed which stipulates all the conditions that govern the lease. This sets out the qualitative terms in the main part of the document while the equipment details, credit limits, rental profile and other details are provided in the attached schedules.

To simplify the process of executing and integrating the specific lease arrangement, the master lease agreement provides that:

(i) the lease of equipment is governed by the provisions of the master lease agreement;
(ii) The details of the leased equipment shall be communicated to by the lessor to the lessee and
(iii) The lessee's consent and confirm that the details to be provided by the lessor shall be final and binding on the lessee.

Clauses in Lease Agreement: There is no standard lease agreement, the contents differ from case to case. Yet a typical lease agreement shall contain following clauses:

(i) Nature of lease: This clause specifies whether the lease is an operating lease, a financial lease or a leveraged lease. It also specifies that the lessor agrees to lease the equipment to the lessee and the lessee agrees to take on lease from the lessor subject to terms of the lease agreement, the leased asset.
(ii) Description of equipment
(iii) Delivery and re-delivery of asset
(iv) Lease Period & Lease Rentals
(v) Uses of assets allowed
(vi) Title: Identification and ownership of equipment
(vii) Repairs and maintenance
(viii) Alteration and improvements
(ix) Possession: must detail – charges, liens and any other encumbrances.
(x) Taxes and Charges
(xi) Indemnity clause
(xii) Inspection by lessor
(xiii) Sub-leasing: prohibition or allowed
(xiv) Events of defaults and remedies
(xv) Applicable law, jurisdiction and settlement.

Apart from the main / master lease agreement the attachments consists of

(i) Guarantee agreement
(ii) Promissory note
(iii) Receipt of goods
(iv) Power of attorney
(v) Collateral security and Hypothecation agreement.

ACCOUNTING / REPORTING FRAMEWORK AND TAXATION OF LEASING

An appropriate method of accounting is necessary for income recognition of the lessor and asset disclosure for the lessee. The concern for a proper method of

accounting for lease transaction is based on two considerations. In the first place, there is likely to be a distortion in the profit and loss account if lease rental is recognized as per the lease agreement. Secondly, distortions are also likely to occur if the assets taken on lease are not disclosed in the lessee's balance sheet.

Research Papers, Articles in Journals and Magazines on lease financing (for reference)

LEASING INDUSTRY IN INDIA: PROBLEMS AND PROSPECTS

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A Lease is a contract whereby the owner of an asset (the lessor) gives to another party (the lessor) gives to another party (the lessee) the right to use the asset, usually for an agreed period of time in return for the consideration of rent. The objective of this paper is to deal with the problems faced by leasing companies in India; and to assess the prospects of the Indian Leasing Companies in India; and to assess the prospects of the Indian leasing industry. The conclusions are based on 28 lessors' questionnaire-response and the outcome of the indepth interviews of the executives of leasing companies. The paper is presented in three sections. The first section provides an introduction of the growth and structure of the leasing industry; the second deals with the problem-areas of leasing, and the last section dwells on the prospects of leasing business in India.

The equipment leasing has significantly grown all over the world. Even in India, the growth of equipment leasing has been phenomenal. During the last five years, literally 600 leasing companies have been floated in India, of which around 100 are active. It has also been observed that a large number of industrial organisations, both in the private and public sectors are considering leasing as one of the alternatives for financing the equipment acquisition. Presently, leases have come in all modes, sizes, and varieties. A large number of companies are using or have plans to use leasing as a source of finance in one way or the other. It is interesting to note the rising share of leased assets to the total investments on assets. For instance, the share of leased assets to total investments ranged from 5 per cent to 33 per cent in 1988 in the EEC countries, and the US, respectively. These developments have touched India also. In India, today equipment, from satellites to aircrafts to autos are obtained through leasing.

Leasing companies have grown from a few lessors in 1980, to more than 600 (public and private limited) by 1988. In India, the equipment leasing boom began in 1985, rapidly covering plant and machinery, furniture and fixture, vehicles, computers, and household durables. However, it is to be noted that though the number of leasing companies increased phenomenally, the size of business in terms of leased assets did not increase accordingly. Table 1 presents an estimate of the assets leased from 1984 through 1990. The growth is noticeable but not very pronounced. However, In India, the share of the leased assets formed less than 1 per cent, in spite of over 600 companies coming into existence by 1988.

It is observed from the leasing market that leasing companies started quoting different lease rentals for the same transaction. A majority of the companies declared dividends ranging from 15 to 25 per cent from the first year of operations itself.

Current Scenario

The year 1989 saw stabilised leasing industry, which is trying to consolidate its position in the market. The RBI implemented the norms for bank finance to leasing companies and issued guidelines on public deposits. On the one hand, the public sector companies showed interest in acquiring assets through lease financing, and on the other, financial institutions, such as IFCI, IDBI, LIC, UTI, etc., and banks have come forward to lend to the leasing companies. Other commercial banks also floated their own subsidiaries to undertake leasing and other Merchant banking activities. The Credit Rating Information Services of India's (CRISIL) rating has also helped a few leasing companies to establish their market for public deposits. The 1990-91 budget has once again created a conducive climate for the growth of the leasing business by abolishing Section 115J of Income Tax Act 1961. Thus, the demand for leasing business is expected to grow further. It is expected that the importance of leasing industry in India is bound to increase with the passage of time and growth in industrialisation.

Table
Assets Leased by Industry (Rs in crores)

Year	Assets Leased during the year	Cumulative assets leased
1984	50	170
1985	80	250
1986	180	430
1987	220	650
1988	365	1015
1989	517	1532
1990	870	2402

Source: Estimate based on the basis of annual reports of leasing companies and other press reports collected by the author.

Structure of Leasing Industry

Today, there are over 400 private and public limited leasing companies in the country involved in diverse leasing activities. A large number of them are private sector companies. This is in contrast to the western counterpart, where mostly subsidiaries of banks and approved financial institutions dominate the leasing scene.

Private Sector Leasing

Presently, this segment consists of about 400 leasing companies, and plays a significant role in providing lease finance facilities to different industries and helps raise funds from various unexplored sources. The following are the important constituents of the private sector leasing industry.

Pure Leasing Companies:

These companies, floated to do exclusively leasing business, operate independently without any link or association with any other organisation or group of organisations to do leasing business. A few examples of such organisations are the First Leasing

Co of India Ltd. (FLGI), The Twentieth Century Finance Corporation Ltd. (TGFL), and the Grover Leasing Ltd.

Hire Purchase and *Finance Companies*
These companies were floated prior to 1980 to do hire purchase and finance business, especially vehicles, and partly, invest in shares and debentures of other companies. During the post-80s, they added leasing to their activities and turned into leasing companies. In this segment, a few companies treat leasing as a major activity, while some others accept leasing on a small scale as a tax-planning device. These are older than other companies in the leasing industry. A few such companies are: Sundaram Finance Ltd (SFL), Mercantile Commercial and Credit Corporation ltd. (MCCL), and Motor and General Finance Ltd. (MGF).

Subsidiaries of *Manufacturing Group Companies:*
These companies consist of two categories: (I) subsidiaries of manufacturing companies, known as vendor leasing companies; and (ii) in-house leasing (captive leasing) companies. The objective of the former is to boost and promote the sales of its parent companies' products through offering leasing facilities. On the other hand, the captive leasing companies are floated to meet the group companies' fund requirements. Some of the in-house leasing companies are also set up to avoid the income tax by the group companies. Another objective of this type is to raise funds to a large extent from outside sources, by using the group's name; since leasing companies are allowed high debt-equity ration of 10:1 tax avoidance is suspected to be the major objective of the in-house leasing companies. For example, the needs of the loss-incurring company by extending leasing facility at a very low rentals (which even are not sufficient to recoup the cost of equipment) and by simultaneously leasing to a profit-making company within the group at an extremely high rentals (to compensate for the loss incurred in other transactions) and reduce the tax burden of a profit-making company. The leasing company earns sufficient profit to compensate for the losses in leasing transactions with loss-incurring companies within the group.

The profit-making company is benefited because of the tax deductibility of high lease rentals. Thus, the taxes which ought to have bolstered government revenues are channellised into loss incurring company of the group.
Because of these advantages, big industrial houses jumped into the fray by setting up in-house and vendor subsidiary companies. Perhaps, this has led to a proliferation of in-house set-ups. For example, Swadeshi Leasing Ltd was floated by the Hindustan Motors Ltd., the key Leasing Ltd. by JK Synthetics Ltd., the Classic Leasing by ITC Ltd., Nagarjuna Finance Ltd., by the Empire Industries, Eligi Equipment Finance by the Eligi Group, and DCL Finance by DCL Group. A few examples of subsidiaries of manufacturing companies are Ashok Leyland Finance Ltd. of Ashok Leyland Ltd., Krest Development and Leasing Ltd. of Best and Crompton Ltd., Bajaj Auto Finance of Bajaj Auto Ltd., and Enfield Finance of Enfield India Ltd. Besides, a few leasing companies are subsidiaries of finance and leasing companies - Cholamandlam Finance Ltd is a subsidiary of Cholamandlam Investment and Finance Ltd., Response Hire

Purchase and Credit Ltd. of First Leasing and Empire Credit Ltd. belongs to Empire Leasing. Further, four leasing companies were floated jointly by banks, the International Finance Corporation (IFC), and private leasing companies. Most leasing companies are engaged in the business of leasing, and hire purchase financing. In leasing, they are primarily concerned with equipment financing, ranging from machine tools to big earth moving and chemical plants. A few companies also engage in real estate business and property development, and one or two companies are also involved in leasing of safe deposit lockers in almost all major cities in the country.
Public Sector Leasing

The public-sector leasing organisations are divided into (a) leasing divisions of financial institutions; (b) subsidiaries of nationalised commercial banks; and (c) other public sector leasing organisations.

Financial Institutions:
Financial institutions, an important constituent of the public sector leasing industry in India, were created with the basic objective of providing long-term finance to the private sector firms. They have recently started leasing business as one of their activities through their leasing divisions or subsidiaries. They include ICICI, IFCI, IRBI, the National Small Industries Corporations (NSIC). Similarly, the Shipping Credit and Investment Company of India (SCICI) emerged as the first financial institutions to offer lease facilities in foreign currencies. However, SCICI is specialising in leasing of ships, deep-sea fishing vessels and related equipment to its clients.

Subsidiaries of Commercial Banks:
Presently, this is the growing segment of the public sector leasing industry. Consequent upon the amendment of Section 19(1) of the Banking Regulation Act 1949, banks can set up subsidiaries for undertaking leasing activities. Hence, banks are setting up subsidiaries with not less than 51 per cent of shareholding, for transacting equipment- leasing business or to invest in shares within the limits specified in section 19(2) of the Act. The aggregate investment of a bank in a subsidiary and/or not in shares of the leasing companies should not exceed 10 per cent of the paid-up capital and reserves of the bank. The pioneers in this segment are SBI Capital Markets Ltd., (SBI Cap) and Canbank Financial Services Ltd. (Canbank), wholly owned subsidiaries of the State Bank of India, and Canara Bank, respectively. Both these companies have already undertaken leasing in a big way. Recently, a few other banks have also joined the bandwagon - BOB Fiscal Services Ltd., a subsidiary of the Bank of Baroda, BOI Financial Services Ltd., a subsidiary of the Bank of India, PNB Capital Services Ltd., a subsidiary of the Punjab National Bank.

Other Public Sector Organisations
A few State-level industrial development organisations, such as the State Industrial Investment Corporation of Maharashtra (SICOM), the Gujarat Industrial and Investment Corporation (GIIC), and the UP Industrial Investment Corporation (UPIIC) have floated their own subsidiary leasing companies. A few public sector manufacturing companies, such as the Electronics Corporation of India Ltd. (ECIL), CMC Computers Ltd., the Bharat Electronics Ltd. (BEL), and the Hindustan

Packaging Co Ltd. (HPCL), have also started leasing to sell their equipment through lease rather than outright sale.

Problems

Growth, financial or economic, in its wake brings problems, and leasing is no exception. With this in view, it was decided to inquire into the problems and prospects of leasing industry in India through an empirical survey. The following sections are based on 28 lessors' questionnaire-response and the outcome of the in-depth interviews of the executives of leading leasing firms.

The phenomenal growth of leasing companies, their lease business, and the acceptance of leasing as a method of acquiring assets, however, have raised some problems. Increasing attention, therefore needs to be given to the following problems of leasing companies of India. The main problems are: resource crunch; inadequate tax benefits and sales tax burden; rigid procedure for import/cross-order leasing; lack of proper and integrated accounting standards; lack of proper and integrated accounting standards; lack of legislation; existence of cut-throat competition; and lack of expertise in the management.

Resource Crunch

The sources of finance available to leasing companies are: (a) equity share capital; (b) reserves and surplus; (c) debentures; (d) long-term loans; (e) public deposits; (f) bank loans; and (g) inter-corporate deposits and other sources. Of late, looking at the performance and prospects, investors seem to have lost confidence in leasing companies. This is reflected in the fact that the shares of most leasing companies are quoted at an extremely lower price, compared to the book value and per value. Therefore, it is becoming difficult for the leasing companies to raise equity share capital in the existing conditions. It is also not possible for them to issue either fully or partly convertible debentures because these are closely linked with the net-worth and trading of equity shares in the market.

The nature and amount of bank finance made available to leasing companies were not subject to any restrictions until recently. The Reserve Bank of India appointed a committee under the chairmanship of GS Dahotre to structure the norms regarding bank finance to leasing companies. Based on the recommendations of the committee, the following guidelines have since been issued by RBI with regard to bank finance.

The bank borrowings of a leasing company cannot exceed three times its Net Owned Fund (NOF). NOF = Paid-up capital + Free Reserves - Accumulated Balance of Loss - Balance of Deferred Revenue Expenditure - Intangible Assets - Investment/ Deposits with subsidiary companies/affiliates - Loans and advances due from subsidiary companies/affiliates).

Banks can extend credit only in the form of a cash-credit facility since financing is done primarily against lease rentals receivable.

For each lease transaction, the borrowing limit will be arrived at with the help of the following formula:

Lease rentals receivable for the next 5 years X 75% of the cost of the leased asset
Total lease rentals receivable for the Entire period

The overall during limit for leasing company will be aggregate of the limits calculated as above for the individual transactions. The cash credit facility offered will be on a revolving basis. That is, as the liability/drawing limit for the earlier leasing transactions are liquidated or reduced, the drawing limit for other new lease transactions can be availed.
Bank finance will be available for only finance leases of new equipment. Hence, operating leases are not eligible for bank finance. Also, sale and lease back arrangement and leases of second-hand assets are not eligible for bank finance. For smaller and medium companies, it will be difficult to raise funds by way of bank loans.

The public deposits are the significant source of the leasing companies. The RBI has amended the earlier Non-Banking Financial Companies Directives, 1977, effective from 28 March 1989. Two important provisions of these directives are: (1) minimum period for acceptance of deposits by equipment leasing companies has been increased to 24 months from six months; and (2) the maximum period extended from 36 months to 60 months. However, the rate of interest cannot exceed 14 per cent per annum. It is observed from the examination of the annual reports of the companies for the year 1987-88 that in terms of size of the public deposits, there were nine companies (29 per cent) in the range of more than Rs.10 crores, - Lakshmi General Finance Ltd. with Rs.45 crores, Sakthi Finance Ltd. Rs. 42 crores, the First Leasing Co of India Ltd. Rs.21 crores, the Investment Trust and Finance Ltd. Rs. 19 and the Industrial Credit and Syndicate Ltd with Rs.14 crores, followed by Nagarjuna Finance Ltd. Rs.13 crores. All these are south-based, especially Madras-based. One company is north-based - The Motor and General Finance Ltd. (MGF) having public deposits of Rs.35 crores. It is evident from this that Madras-based companies have mobilised deposits to the maximum extent as they have branches all over the country.

A look at the branch network of the selected companies reveals that most of the south-based companies have more branches than other leasing companies. Thus, Sundaram Finance Ltd. has 39 branches, followed by Sakthi Finance Ltd. with 27 branches Mercantile Credit Corporation Ltd. 23 branches, the Industrial Credit and Development Syndicate Ltd. 22 branches, the Investment Trust of India Ltd. 19 branches, and Lakshmi General Finance Ltd. 13 branches. Only one of the north-based companies, Grower Leasing Ltd., has ten branches. The major concern of these branches appears to be mobilising deposits from the public directly or indirectly through fixed deposits brokers rather than doing leasing business. The leasing companies used the branches as an instrument to mop up fixed deposits. In addition to the branch network, a few leasing companies had used CRISIL's rating as a weapon to boost their fixed deposits. Sundaram Finance Ltd., Cholamandalam Investment and Finance Co Ltd. (CIFIL), from Madras, and the 20th Century Finance Corporation (TCFC), Bombay, had approached CRISIL, for rating and were awarded, FAAA (Triple A) which stands for highest safety. Another company from Bombay, the Empire Finance Co Ltd., was awarded FA + which stands between FAA (high safety) and FA (adequate safety).

Presently, leasing companies are facing problems in raising fixed deposits since the minimum period of deposits is two years. Only good and big companies may be able

to borrow by way of deposits. Thus, it is indicated that there is going to be an acute shortage of money - the raw materials of leasing companies.
According to Ramakrishna Rao, Managing director, Magnificent Leasing, while the demand for leasing increased, raw material supply (resources) became a severe constraint. A few companies also had management problems, this being a specialised business. Ranina, an expert in taxation and chairman, Mazada Leasing has said: All leasing companies are facing the problem of resource crunch. Most of the companies have not been able to raise any funds since 1986-87". Similarly, our analysis of the responses to the questionnaire showed that, four companies (14 per cent of the respondents) faced problem in raising share capital and long-term debt, and eight respondents (29 per cent) in getting bank finance, whereas 15 respondents (58 per cent) had problem in mobilising public deposits.
Inadequate Tax Benefits

Unfortunately, the tax benefits which leasing companies enjoy in the developed countries are not available to the Indian leasing companies. Tax benefits arising out of depreciation, investment allowance of deposit scheme, etc., are not conducive to the growth and promotion of leasing companies. Investment allowance (u/s 32A) was abolished from 1 April 1987, and in its place an investment deposit scheme (u/s 32 AB) has been introduced. Under this scheme, the amount of deduction is limited to 20 per cent of the profit of eligible business or profession as per the audited accounts. However, this scheme excludes certain categories of leasing. The latest position is that even this has been abolished as announced in the budget of 1990-91

In addition to the above, the Finance Act 1987, had introduced Section 115J of Income Tax Act, 1961 which provided for a minimum tax of 30 per cent on the book profits of a company. The leasing companies brought within the orbit of this new tax provision faced uneasiness; now this has been abolished, as announced in the budget 1990-91.

Sales Tax Problems
Leasing companies are also facing the problems of sales tax. The 46th Amendment to the Indian Constitution, which came into force from February 1983, has empowered the State governments to levy sales tax on the transfer of rights or to the use of any goods for valuable consideration. As a result, the legal position of finance lease is a "deemed sale" under the State Sales Tax Act. The governments of Andhra Pradesh, Bihar, Gurjarat, Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh, Orissa, Tamil Nadu, and West Bengal have already amended their sales tax Acts in accordance with the 46th amendment to the Constitution. Hence, leasing companies are required to pay sales tax at higher rates on a lease transaction as they are not being allowed to use 'G' forms. This makes leasing more expensive, as the cost of the asset acquired under lease finance gets enhanced to the extent of sales tax paid by the leasing companies. This is bound to cripple the leasing industry, which is still in the nascent stage. In view of the burden created by sales tax, the Central Government should take immediate steps and formulate guidelines, ensuring uniform legislation among various States. It should ensure uniformity in the scope and contents of the sales tax. The facility of using 'G' should also be extended to leasing companies.

Prabhu, Chairman, Canara Bank in his chairman's speech in June 1989 remarked that there were certain avoidable constraints restraining the lease finance from becoming a major source of corporate finance. The levy of sales tax on rentals by many State governments makes leasing unattractive. The benefits of lease finance, in terms of accelerated modernisation and industrial growth, are to that extent adversely affected.

Yet another problem is in obtaining approval for issue of 'C' Forms by lessors under the Central Sales Tax.

It is noticed from the analysis of the questionnaire responses that 100 per cent of the respondents suggested that Section 115J of the Income-Tax Act, 1961, and sales tax on lease rentals should be abolished with immediate effect. About three-fourths of the respondents expressed that the investment allowance and investment deposit scheme should be extended to the leasing companies. The leasing companies would feel relieved since Section 115 has been scrapped.

Rigid Procedure for Import Leasing

In India, Leasing industry has high potential in areas like import leasing or international leasing. Recently, a few leasing companies entered the arena of import leasing. The import and Export Policy for 1985-88 has laid down the following eligibility criteria for leasing companies to do import leasing.

- The memorandum and articles of association of the leasing company must specifically provide for leasing as one of the objectives.
- The leasing company must have a minimum paid-up share capital and reserves of Rs.1 crore.
- The share of leasing company must be listed in a recognised stock exchange.
- Thus, leasing of imported equipment has been restricted to a meagre part of the industry. A number of respondents indicated the problems of import leasing and made the following suggestions:
- Import of OGL items to be permitted without approval of the Joint Chief Controller of Imports and Exports (JCCI & E).
- The Chief Controller of Imports and Exports (CCI&E) has to reduce the period for giving permission for import leasing.

Accounting Problem

The Indian leasing companies are following a variety of lease accounting practices. Lessees neither show the leased assets on the asset side nor the future lease rental obligations as liabilities. Therefore, the lease transaction seems to be an off-balance sheet transaction. Lessors show the leased assets as owned assets in their balance sheets, even though they lose the economic possession of assets by making finance lease.

The first flaw is reporting the lease income in the financial statements. It is evident from the examination of books that the accounting practices of various leasing companies have been far from uniform and consistent. The leasing companies are not amortising the value of the leased asset during the primary lease period (period in which leasing companies recovered more than 95 per cent of the asset value). Instead of amortising the full equipment cost, leasing companies are debiting a small part of the leased asset's cost by way of straight-line depreciation in the books of accounts.

The depreciation is being shown for more than eight years, even though there would not be any income through the asset. Hence, in such a case, the basic accounting concept of matching the cost with revenue is totally ignored.
The second flaw lies in showing the leased assets in the balance sheet. Different leasing companies have adopted a variety of methods and there is no consistency in the presentation of accounts. It is interesting to note that the method of providing depreciation is also different from that of owned assets. Leasing companies are following written down value methods of depreciation for owned assets and straight - line method for leased assets.
In the light of these practices, the Institute of Chartered Accountants of India (ICAI) has issued a "Guidance Note on Accounting a Leases". The following are some of the important requirements.

a) The assets leased out should be shown under "Fixed Assets" separately as "Assets on Lease" and classified in the same manner as other fixed assets.
b) A matching annual charge representing the difference from the lease and finance income is to be debited to the profit and loss account. This annual charge will consist of the minimum statutory depreciation as per the Companies Act, and lease equalisation charge where the lease charge is in excess of the said depreciation.

The recent amendment to the Companies Act, 1956, ensures that all the companies including leasing companies, should follow accrual system of accounting. This will cause unnecessary hardship to the leasing companies. However, there is disagreement in the treatment of depreciation allowances, possessions of assets under the Income-tax Act, 1961, and the Indian Companies Act 1956. There is thus a strong discontentment among leasing companies regarding the accounting treatment in their financial statements. The leasing Industry feels that the ICAI did not provide adequate transition period for the implementation of the guidance note. In this connection, the Equipment Leasing Association (ELA), India, made representation to the ICAI indicating the need for providing a reasonable transition period till the requirements are in agreement with that of tax, monetary, and corporate policies and practices. In fact, a group of leasing companies obtained a stay order in Madras High Court, preventing ICAI from implementing the provisions of the guidance note. ELA, continuing its constructive approach with ICAI, has suggested an alternative method of providing depreciation.

Lack of Proper Legislation
In fact, the only legal reference available to lessors and lessees in the Hire Purchase Act, 1972. Another act, the Transfer of Property Act (Sections 105 to 117), deals with only immovable properties. Even today, the leasing industry is following these acts in addition to the section 126 to 180 of the Indian Contract Act, 1872. Hence, it is obvious that there is neither a comprehensive leasing law nor government policy to guide the leasing business. Now, it is the right time, for the Central Government to make efforts to pass an act know as "Indian Lease Act," to cover leasing business.
The private sector leasing companies are facing cut-throat competition from the public sector leasing organisations, such as ICICI, IFCI, SBI Cap, and Canbank, Compared to the small private sector companies; these are at a privileged position in

that they get funds at cheaper cost. Therefore, these public sector leasing organisations have good tie-ups with blue chip and big companies and public sector manufacturing companies. These have better terms and conditions than the private sector companies. Besides, keen and unequal competition exist even among the private sector leasing companies because of the oligopolistic nature of the leasing industry. Sometimes, highly profitable and high tax companies may also create competition by offering lease finance in order to avoid the income tax through leasing as a tax-planning device.

Management Problem

Without knowing the lease business, a large number of entrepreneurs had entered the leasing fray with others money. Management of leasing fray with others' money. Management of leasing companies thus requires a different orientation compared to the management of manufacturing and trading companies. The leasing companies need people with specialised knowledge and skill to evaluate and appraise the credit worthiness and soundness of the potential as well as existing lessees from time to time. The leasing companies need to evaluate the structure of innovative lease packages and options in order to cater to the needs and requirements of different segments of the market.

The second issue relates to the composition of the board of directors of leasing companies. A scrutiny of the board of directors of leasing companies reveals that almost all the board of leasing companies are dominated by the retired chairmen/managing directors or chief managers of banks or financial institutions. Moreover, the same person is associated with many such companies. What is interesting is that most such directors do not have any financial stake in the leasing companies! The objective of the promoters in including such popular figures is to attract instantaneous response to public issues, whereas, the retired executives are finding these offers as retirement benefits. What is worse, most of these directors do not have either the time or willingness to devote attention to the regular and routine business. If these directors provide efficient and effective guidance and supervision, how come some of the leasing companies have diversified into unrelated areas and a sizable number disappeared from the scene?

According to Vinay Sawhney, Chairman of the Worldlink Finance Ltd.(chairman's) speech, Third AGM, 28 March 1989), the leasing industry in India has failed to make any significant contribution to the process of capital asset formation in the past few years due to (a) limited resource mobilisation capabilities, (b) restrictive bank support, and (c) lack of trained manpower. He suggested that careful planning, systematic institution building, innovative approach, and well throughout staff training programmes are the key to the ultimate success in leasing business. According to Santhanam, Chairman, Sundaram Finance Ltd. (Speech in 34th AGM 24 Sept 1987), there has been a keen competition in leasing business from the financial institutions and subsidiaries of commercial banks.

An analysis of responses on problem areas of leasing indicates that almost all the companies faced one or the other problem in the leasing market. They have referred to a number of factors affecting the financial performance of their companies (Tab 2).

Table 2 shows that about 90 per cent of respondents stated that sales tax on lease rentals and Section 115J of the Income Tax Act, 1961, have affected the financial performance of the companies, and half the respondents felt that competition is keen and intense. Only a few cited other problems. It is also noted that about one-third of the respondents indicated that they have marketing problems, such as under-quoting of lease rentals (rate war) by competitors, and special and innovative schemes of leasing divisions of financial institutions and subsidiaries of banks. About one-third of the respondents expressed that there is a need for the lease broker services to facilitate marketing functions of lease, while the rest of them (three-fourths) felt otherwise - no need for broker services.

Table

Description of Problems by respondents

Description of problems	No. of companies	Percentage
Competition is keen and intense	12	46
High interest rate burden	3	12
Lack of business opportunities	3	12
Defaults in rental payments	2	8
Sales tax on lease rentals	26	93
Income-tax under Section 115J	25	90
High cost of operation	5	19
Low margin/unprofitable rentals	4	15

As regards policy issues, 20 respondents (70 per cent) suggested that the Central Government should take immediate steps to abolish the sales tax on lease rentals and Section 115J of the Income Tax Act, 1961 to give a boost to the industry. (Section 115J has been abolished in the budget 1990-91). More than half the companies suggested that leasing companies should also be allowed to avail the investment allowance and investment deposit scheme. (However, these two were abolished in the budget 1990-91). One-fifth of the respondent wanted the minimum period of public deposits to be reduced to six months, against the current period of 24 months, while a few also stated that bank finance to leasing companies should be increased to five to six times their net-owned funds. A few respondents felt that there is room for simplifying the procedure for import leasing. From the foregoing, it can be concluded that the major problems of the leasing companies are: the high incidence of sales tax on lease rentals; cut-throat and keen competition; inability to raise resource on a continuous basis, in case of both new and old companies due to varied reasons; no legislation to guide, direct, and control leasing companies and leasing business; and lack of a trained and experience manpower.

Prospects

Despite these problems, the leasing business in India has its own growth potential and prospects. Equipment leasing has come to stay as a new device in providing the necessary resources for maintaining the tempo of industrial growth. Leasing has acquired a special importance in the economics of the developing countries, particularly for financing the small-and medium-scale industries. Capital formulation

through leasing can help growth with minimum investment. It is estimated that by the end of March 1991, the Indian leasing industry raised capital from various sources approximately to the tune of Rs.4,000 crores.

Leasing has great potential in India in view of the fact that barely less than 1 per cent of the total industrial investment is so far financed through leasing, compared to 30-40 per cent capital investment through leasing in the developed countries, such as the US, the UK, and 10 to 20 per cent in Australia, Canada, Japan, etc. The well-managed and large resourceful leasing companies are going to see better days with good profitability during the next few years. The leasing business continues to grow and flourish, and the consumers - lessees (different segments of market) are growing in number and size. Demand for leasing business continues to grow at a faster rate, and there is adequate space for all. In the coming years, perhaps, the fastest and largest growth industry would be leasing since the public sector organisations are actively involved in the industry not only as lessors but also as lessees.
Financial institutions are armed with much inexpensive and comparatively vast funds in their hands for deployment in leasing. These bodies can, therefore, function as catalysts for market growth for leasing rates and, therefore, influences the profitability levels. Several financial bodies, notably subsidiaries of banks or financial institutions, are taking substantial amount of leasing from the public sector units, such as ONGC, Air-India, Indian Airlines, Shipping Corporation, HMT, SAIL, BHEL, BEL, Vayudoot, Coal India Ltd., and service-oriented sectors like transportation and communication departments, and professions, such as medical, consultancy, engineering, etc.

The financial institutions and subsidiaries of commercial banks on the one hand, and the private sector leasing companies, on the other, may have to play an important role in the development of the leasing business. Recently, there was a proposal from the Asian Development Bank (ADB) to set up a 100 crore Indian Leasing Industry fund which has been approved by the Central Government. The fund is to be jointly promoted by ICICI, UTI, and ADB. The Indian public is likely to have a stake in the fund. The main objective of the fund is to provide long-term loans to the private sector finance companies. Another notable development is that the Equipment Leasing Association of India (ELA) at Madras, and the Association of Leasing, Finance and Housing Development Companies (LFH), at Bombay, were formed with a (view) to promoting, aiding, helping, encouraging the leasing business, and protecting the interests of the leasing companies. Besides, a few of the finance, accounting, tax and management consultants are working as lease brokers, who also will contribute to the growth of leasing business.

Leasing companies are not only useful to big and medium industries but also opened a new window for financing professionals, and consumers; they are also contributing to the growth of the consumer goods industries. Leasing companies will get an additional inflow of relatively inexpensive funds from IDBI, IFCI, UTI, since they offer medium-term loan at 15 per cent interest. Their branch networks are working in full swing in exploring new markets for public deposits. A few leasing companies have even set up mobile offices to mobilise more fixed deposits from investors at their offices and residences.

Presently, leases in India are generally small-ticket leases. The equipment ordinarily leased are plants and machinery; however, the important potential markets are heavy plant and machinery, ships aircraft, satellites, data processing equipment, trucks, chemical plants, high-tech equipment by means of import leasing, leveraged leasing, and vendor leasing. Leasing has also plenty of scope in the service sectors, such as developing the transportation and communication industries. Recently, the Motor Vehicles Act has been amended for incorporating the interest of the lessor in the registration certificate. This was a long awaited demand of the industry, and the government has done well in recognising the importance of the leasing industry in developing the transport sector. This will help increase the vehicle leasing for transport and non-transport industry. The electronic and technological revolution sweeping the office automation and data processing would create ample scope for leasing.

Leasing is a service industry as it provides funds and also taps the capital market. It supplements the government's developmental plan by supplying equipment to the industry. The Eight plan's projections, coupled with the flexible government policies towards industry, modernisation and expansion of capabilities and the emphasis on technological up-gradation augurs well for the prospects of leasing. The Central Government has reacted fairly as far as monetary, fiscal, and regulatory policy issues were concerned. The manner and direction of growth will be, to some extent, affected by fiscal, monetary and economic policies, although leasing industry is not dependent upon them. Leasing will thrive whatever be the fiscal and monetary system adopted, provided only that it does not treat leasing disadvantageously.

Leasing is growing industry. It is seen that leasing has grown in the latter 80s, and is still growing. It is, however, worth nothing that despite good prospects for leasing, many existing private sector leasing companies do not find a place in the market; only a few leaders from the private sector, besides the public sector, remain in the fray. This shows that the leasing industry needs the full support, co-operation, and encouragement of the government. At the same time, regulatory framework is essential to control its mushroom growth and irregularities, and to ensure a healthy growth. It is expected that a substantial number of manufacturers of many types of equipment may set up their leasing operations either as an integral part of the parent company or through a subsidiary to sell their products. As long as the leasing industry continues to be innovative, it will find a ready market for the service it has to offer.

LEASING KNOWS NO FRONTIERS!!!

Apart from the need to raise finance in the international financial markets, cross-border leasing transactions mostly involve tax benefits, claimed in the country of residence of the lessor, the lessee, or both.

In recent years, the cross-border leasing market involving Dutch-based moveable and immoveable assets has continued to be very active. Cross-border leasing transactions involving power plant and waste management facilities operated by Dutch utilities, and leasing transactions involving railroad stock and Dutch-operated aircraft, have all attracted extensive publicity in recent years.

The Dutch tax system particularly facilitates cross-border leasing transactions. This is the result of a combination of factors, including the absence of withholding tax on cross-border interest and rental payments, and the willingness of the Dutch tax authorities to confirm the tax treatment of a particular transaction in advance.
Lease financing for the purchase of aircraft, transportation equipment, industrial machinery, and other types of equipment is available across nations. Capabilities indispensable for the structuring of cross-border leasing arrangements include an in-depth knowledge of the asset value of the items leased, an ability to move quickly and flexibly along with market trends, and knowledge of detailed information on legal, accounting, and tax matters.

How to Proceed?
Once a lessee decides to go ahead with cross-border leasing, what are the steps to be followed?

Identifying a Lessor
Cross border lease is very different from conventional domestic finance transactions hence, identifying a lessor is the most tedious job. For example, the capital markets in the United States, are extraordinarily deep. However, cross-border transactions may involve jurisdictions like in Sweden and Denmark, which have low levels of equity available at any given time. Germany and Japan have larger equity markets, but other factors like tax laws and defeasance requirements, demand for manufacturing equipment from the lessor's country, overall economic conditions, and the appetite for tax-oriented transactions at a specific time can constrain opportunities to close cross-border leases.

Understanding the Participants, Terms and Conditions of the transaction
Market participants are unique in each country, and unrelated to the players in domestic financial markets. The most distinguishing features are the terms, conditions and transaction structures. Issues like, defeasance arrangements or title may sometimes result in "hung-up" deals (deals without any further action).

Working with a financial advisor
Some lessees prefer to appoint a legal counsel or an advisor who is experienced in the cross-border leasing field. There are two general options available to the advisor for designing a cross-border lease:

- Develop a bid specification to select the placement agency, quoting the highest net benefit and best risk sharing arrangements. Or
- Use competitive appraisal process to identify a placement agent, who will then act on behalf of the lessee to solicit competitive bids from equity sources in targeted countries, as well as conduct a competition for defeasance arrangements among banks or investment bankers.

Understanding "how the deal works"
It is important to understand the working of the deal. The following two basic questions need to be answered:

1. How market participants are compensated?
2. What are the local procurement regulations governing the transaction?

Some jurisdictions allow negotiations for advisors and underwriters, while others use competitive bidding. A typical cross-border lease transaction may involve multiple procurements say, placement agent, equity, debt, deposits, lessee counsel, appraisers, currency-related financial products and the like. This sometimes results in the lessee preferring a complete package. For example, Avenue Corporate Services Pvt. Ltd., Misha Consultancy Nexus India Ltd. are a few consultancy firms that provide professional advisory and consulting services in cross-border leasing.

Evaluation Factors

Cross-border leasing is a highly specialised field; hence the following factors demand consideration:

- Volume and history of successfully completed cross-border lease transactions.
- Continuous history of involvement in the cross-border field.
- Ongoing presence in overseas markets, and familiarity with the countries that are the most likely sources of equity for the assets to be leased.
- Recent track record in identifying equity and closing transactions while serving as financial advisor in comparably scaled deals covering similar types of assets.

The global market conditions like interest rates, depth of capital markets and tax law environments are volatile rendering sensitivity to cross-border leases. Therefore, it is advisable to seek leasing proposals three to six months prior to taking delivery of assets, or placing an order. Japanese leveraged leases tend to be more restrictive regarding title issues and it is suggested that these issues, be clearly set out prior to making domestic financing arrangements for the acquisition,

Calculating Costs and Benefits

The benefits derived from a cross-border lease depend to a great extent on the country's' tax laws, the participants' income, and interest rate differentials between the two countries. Exchange rate fluctuations also affect the benefit equation. The costs to achieve that benefit are, the appraisal, legal, financial advisor, and other fees paid by the transit system to undertake the transaction. The remainder is the Net Benefit.

To sum up, Cross-border Leasing in emerging markets is becoming an important tool in trade finance. More and more jurisdictions are gearing up to make it an attractive form of financing.

1. " Defease" means to bank sufficient proceeds from the transaction to cover lease and loan requirements. This may also be accomplished through the purchase of an annuity.
2. Different types of assets and legal title situations

The inability to legally defeat Japanese leveraged leases makes them more attractive for shorter-lived assets, such as buses, telecommunications equipment, or possibly computerized signal and fare collection systems.

Japan does not require that the assets being financed have Japanese manufacturing content. Longer-lived assets, such as rail vehicles, are better suited to the European lease markets because of greater availability of defeasance options.

German lessors tend to require that the assets have German manufacturing content. Equipment for which title has passed to the lessee is not suited to Japanese leasing guidelines, and is more favourably viewed under the European tax environments.

FAQ'S - WWW.MYVAKIL.COM - YOUR LEGAL ADVISOR ONLINE.HTM

1. Can I acquire equipment for my business without buying it?

You can acquire equipment for your business without buying it. You can take the equipment on lease through lease finance.

2. How does lease finance work?

Lease finance is a contract for leasing an asset or equipment. The owner of the asset leases the asset to the lessee conferring the exclusive rights to use and possess the equipment for a specific period. The contract will require the lessee to make fixed periodic payments or 'rent' to the lessor for use of the leased equipment. The contract is known as Lease Finance Agreement. The lessor remains the owner of the asset during the period of lease and after its termination.

3. What are the ways for leasing equipment?

There are three ways by which you can lease equipment:

(i) You can select and order the equipment and then seek financing through a leasing company.

(ii) You can select the equipment by working with a vendor or a manufacturer, who offers leasing through its own subsidiary.

(iii) You can obtain the equipment directly through a leasing company.

4. What are the types of lease I can get?

The two most common types of lease are operating lease and financial lease. A lessee needs to choose between these two types depending upon the type of asset and the period of lease.

5. What is financial lease?

Financial lease is a long-term lease. The lessee uses the asset for its lifetime during the period of lease. The asset will be of no value at the end of the lease period. The period of lease is long enough for the lessor to recover the investment as well as profit in a single leasing transaction.

6. What is operating lease?

Operating lease is a short-term lease. The life of the asset is not consumed in a single lease. The asset is normally capable of being leased more than once. The lessor does not recover the entire investment on the asset from a single lease but recovers the investment through multiple leases.

7. What is the mode of payment of rent in a lease finance transaction?

You can make payments by cheque or demand draft. Generally leasing companies collect post-dated cheques for payment of rent for the entire duration of the lease.

8. Are there advantages in a lease finance transaction?

Leasing is more advantageous compared to other financing options, in that it offers a combination of-

(i) Minimum cash investment

(ii) Fixed payments

(iii) Convenience of upgrading and adding additional equipment
(iv) Tax benefits

9. What are the tax benefits derived by the lessor and lessee in a lease finance transaction?

The lessor claims depreciation on the asset, as he is the owner of the asset during the lease finance period and even after its termination. Depreciation can be claimed on the actual cost incurred by the lessor for the asset at such rates as are prescribed under the Income Tax Act. The lessee, on the other hand, is entitled to claim deductions on the rent paid by him for the asset under the Income Tax Act.

10. Do I have to be a company to take lease of equipment?

It is not necessary to be a company to take lease of equipment. A sole proprietor or a partnership firm can also take lease.

11. Can a house or flat be taken on lease under lease finance transaction?

A house or flat cannot be given or taken on lease, as lease finance must be for a movable asset only. A house or a flat is an immovable asset and comes within the purview of real estate leasing.

12. Can I approach a leasing company for leasing an asset of my choice?

The lessee has the right to select the asset from a manufacturer or supplier of his choice. The lessor only pays the price of the asset and procures it for the use of the lessee.

13. Can I lease equipment for an unspecified period?

You cannot lease equipment for an unspecified period. The period of lease must be fixed.

14. Can the asset be taken back before the expiry of the lease period?

The lessor has an option to cancel the lease and take possession of the asset if the lessee does not comply with the terms of the lease finance agreement.

15. Does the lessor require a guarantee for giving the equipment on lease?

Most lessors require a guarantor as additional security for giving the equipment on lease. If the lessee defaults in payment of lease rentals, the lessor can recover the lease rentals from the guarantor. However, a guarantor is not required when the lessee gives collateral security such as title deeds of immovable property, for complying with the terms of the lease.

16. Does the lease finance agreement attract stamp Duty?

Lease finance agreement must be engrossed on a non-judicial stamp paper of the value of Rs 10/- (Article 5, Schedule I of the Indian Stamp Act) irrespective of the value of the asset or aggregate amount of lease rentals.

17. Does lease finance agreement require registration?

Lease finance agreements deal with movable property and hence registration is not compulsory under the Registration Act.

18. Who should insure the asset under a lease finance agreement?

It is the duty of the lessee to insure the leased equipment. If in any case the lessor insures the leased equipment, he has the right to recover the cost of insurance from the lessee if the agreement provides for it.

19. Will the leasing company provide equipment warranty?

Leasing companies do not normally provide equipment warranties. The manufacturer or vendor of the equipment provides equipment warranties and is solely responsible for service or warranty issues.

20. Can the lessor assign his rights under the lease finance agreement to a third party?

The lessor may assign any of his rights to any person under the lease finance agreement and the person to whom such rights are assigned shall be entitled to the full benefits of such rights. The assignment rights are not available to the lessee. However, the lessee may assign his rights with the prior permission of the lessor or if the lease finance agreement provides for such assignment.

21. Can the lessee transfer the asset to another?

The lessee does not have any right to sell, assign, mortgage, hypothecate or sublet the asset to anyone else, unless the lease finance agreement provides for it, or there is prior written consent of the lessor.

22. What is the difference between lease finance and hire purchase?

In the case of lease finance, the lessee has to return the assets once the lease period expires. In the case of hire purchase, the hirer has the option to purchase the asset on completion of the hire period.

In the case of lease finance agreement, the lessor can claim the depreciation benefit under the Income Tax Act as he is the owner of the asset. In the hire purchase agreement, the hirer can claim the depreciation benefit under the Income Tax Act as he is deemed to be owner of the asset.

Over to lease finance

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Till 1995, project finance for infrastructure was limited to borrowings and equity capital. Over the past three years, however, lease financing has been emerging as a project financier's delight. The power sector, for example, has already completed leasing deals worth Rs 500 crore over the past three years. The Railways and shipping companies have also started opting for this method.

Leasing has become a popular option for infrastructure projects because it suits both bankers and project managers. For banks the advantages of leasing to infrastructure projects is the relatively lower risk. This is because assets in infrastructure leases are secured and lease deals are usually structured in such a way that the possibility of bad debts is lower.

For project managers, leasing also translates into lower fixed and financing costs. A major component of fixed costs, especially in thermal and gas-based power projects and transport projects like the Railways, is basically equipment. Leased equipment reduces overall costs and helps save on subsequent depreciation and interest on funds the company would have otherwise borrowed. The other major advantage of lease financing in projects is that no standard debt equity ratios are applicable, since lease finance does not qualify either as borrowing or equity. This means that companies can operate on a relatively low equity base.

Typically, projects tend to operate on a debt equity ratio of about 2:1. However, for projects for which equipment is leased what matters is not the debt equity ratio but the debt service coverage ratio (the number of times the operating profit is covered the outstanding debt payments). Acceptable ratios would be about two.

The essence of project financing lies in the recourse financiers have to assets. Infrastructure projects allow conventional lenders access only to fixed assets. This is

not of immediate use -- after all, what can a banker do with a power plant of a generating company that has defaulted on loans. But with leasing, financiers actually own the assets, and this gives them the advantage of a tax-saving depreciation shelter.

The benefits of a reduced tax liability can then be passed on to the lessee company. This means that the company's financial costs could be far lower than a conventional term loan would allow. Typically, term loan rates vary from 15 to 17 per cent, depending on the promoter. By contrast, items with a depreciation shelter of about 25 per cent, would attract rental rates of 13 to 14 per cent. A corporate guarantee from a high quality customer would reduce funding costs even more.
But though leasing allows for asset security, lease financiers to infrastructure projects have been concerned about cash flow risks -- which can be high for, say, power generating companies that depend on notoriously loss-making state electricity boards for payment. That is why lease deals in India are increasingly being structured to cover cash-flow risks.

One of the favourite methods of covering such cash flow risks is through structured leasing techniques (Figure 1). The Infrastructure Leasing and Financial Services (ILFS) last year, for instance, worked out a five-year structured leasing deal for Chemplast Sanmar, which was diversifying into shipping. ILFS along with ORIX Corporation of Japan provided the funds for Chemplast's purchase of the ship MT World Castle. The ship, in turn, was given out on a time charter to the governments Oil Coordination Committee (OCC). Chemplast was able to secure a high price for the time charter that allowed for a 12 per cent return on equity. That is, the time charter covered the variable operational costs and allowed Chemplast a minimum return of 12 per cent. As important, the charter payments were assured because they bore a sovereign guarantee.

Despite this assured cash flow which, in turn, would have meant assured lease rental payments, ILFS chose to be circumspect. It opted for an overseas escrow account into which the charter rentals were credited. The ILFS-ORIX combine had first charge on the account, Chemplast second charge. The entire deal was doubly safe for the lease financiers because they were the owners of the ship, which is a relatively liquid asset.
In the Chemplast-OCC deal, there were actually no cash flow risks. But this method could work just as well for power projects where cash flow risks are high because they depend on state electricity boards for payment. In such cases, however, the deal would need to be backed by letters of credit or by bank guarantees. Chemplast is not the only one to use such structure leasing mechanics. The Indian Railways has been increasingly doing so. The Railways is Indias largest lessee; its annual leasing bill could be as high as Rs 500 crore. Although it usually routes its deals through the Indian Railway Corporation, it has also worked out lease arrangements with the State Bank of India, the Industrial Development Bank of India and ILFS.

The first two deals was essentially to finance the Railways rolling stock -- wagons and the like. But the deal with ILFS was unique in that it leveraged a special purpose vehicle or a holding company to raise money from commercial banks and institutions through a syndicated lease.

The Rs 125-crore lease was for acquisition of permanent way hardware (basically railway tracks) for the Konkan Railway Corporation Ltd, which is also a special purpose vehicle created to implement the 1,200 km rail link along the west coast.

The deal worked like this (Figure 2). Konkan Railway Corporation deposits a 20 per cent of the asset value with ILFS. ILFS in turn sets up a special purpose vehicle with this money and leverages it to raise debt from other financial institutions, banks and companies.

But since the assets in this case -- railway tracks -- are virtually illiquid, ILFS created an escrow account into which the Railways deposited parts of its freight and passenger earnings from the Konkan railway. The ILFS-owned special purpose vehicle had first charge on this account.

Now, other finance companies are beginning to look to the Railways for structured leasing deals. GE Caps, for instance, is prepared to offer rolling stock leases up to 20 years. But the major problem with these kind of leases is the mismatch between the depreciation period (written down value) and the tenor of the loan.

The tenor of the lease would have to coincide with asset fully depreciating at the end of the lease period. GE Caps says it can solve this by breaking up the lease period into two legs. During the primary lease period, when the lessor will also benefit from the depreciation rates, the rentals will be high and during the secondary lease period the rentals would be low. But this method has not appealed to the Railways because the overall costs are high -- as much as 19 per cent.

An alternative method would be to domicile the lease elsewhere, where the depreciation rates could match the tenor of the lease. But cross border domiciling of leases could mean that the lessor would have to assume the exchange risk and the Railways is unlikely to agree to this. So the GE Caps lease offers have not elicited favourable responses so far.

Now, state electricity boards have already begun using such methods to finance their asset replacement plans. For instance, the Assam State Electricity Board is negotiating with banks for hydro-electric generation equipment on a structured lease basis. The deal could cost up to Rs 300 crore, making it the single biggest lease transaction in India.

Deals like this could mark the start of big ticket leasing in India. Once this takes off, bankers could find that the conventional high-risk nature of infrastructure funding could change completely.

LESSON 9
HIRE PURCHASE – CONCEPTUAL, LEGAL AND REGULATORY FRAMEWORK

Lesson Objectives:	To understand the Concept of Hire Purchase Finance, Regulations related to Hire purchase.

INTRODUCTION:

Hire purchase is a mode of financing the price of the goods to be sold on a future date. In a hire purchase transaction, the goods are let on hire, the purchase price is to be paid in installments and hirer is allowed an option to purchase the goods by paying all the installments. Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of the last installment.

A hire purchase agreement is defined in the Hire Purchase Act, 1972 as peculiar kind of transaction in which the goods are let on hire with an option to the hirer to purchase them, with the following stipulations:

a. Payments to be made in installments over a specified period.
b. The possession is delivered to the hirer at the time of entering into the contract.
c. The property in goods passes to the hirer on payment of the last installment.
d. Each installment is treated as hire charges so that if default is made in payment of any installment, the seller becomes entitled to take away the goods, and
e. The hirer/ purchase is free to return the goods without being required to pay any further installments falling due after the return.

Features of Hire Purchase Agreement:

- Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.
- Each installment is treated as hire charges.
- The ownership of the goods passes from the seller to the buyer on the payment of the last installment.

- In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charges.
- The hirer has the right to terminate the agreement any time before the property passes. That is, he has the option to return the goods in which case he need not pay installments falling due thereafter. However, he cannot recover the sums already paid as such sums legally represent hire charges on the goods in question.

HIRE PURCHASE V/S INSTALLMENT SALE:

Though both the system of consumer credit are very popular in financing and look similar, there is clear distinction between the two. In an installment sale, the contract of sale is entered into the goods are delivered and the ownership is transferred to the buyer but the price is paid in specified installments over a period of time.

In hire purchase the hirer can purchase the goods at any time during the term of the agreement and he has the option to return the goods at any time without having to pay rest of the installments. But in installment payment financing there is no such option to the buyer. In installment payment, the ownership of the goods is transferred immediately at the time of entering into the contract. Whereas in hire purchase the ownership is transferred after the payment of last installment or when the hirer exercises his option to buy goods.

LEASE FINANCING V/S HIRE PURCHASE FINANCING:

The two modes of financing differ in the following respect:

	Hire purchase	Lease financing
Ownership	Financer is the owner, and owner ship is transferred after payment of last installment.	Financer is the owner, but ownership is never transferred.
Depreciation	Hirer is entitled to claim depreciation benefit.	The lessor is entitled to claim depreciation benefit.
Magnitude	Low	High
Extent	Less than 100% (50-75%)	Up to 100%
Maintenance	Hirer's responsibility	Lessor's responsibility
Tax benefits	Hirer	Lessor

LEGAL FRAMEWORK:

There is no exclusive legislation dealing with hire purchase transaction in India. The Hire purchase Act was passed in 1972. An Amendment bill was introduced in 1989 to amend some of the provisions of the act. However, the act has been enforced so far. The provisions of are not inconsistent with the general law and can be followed as a guideline particularly where no provisions exist in the general laws which, in the absence of any specific law, govern the hire purchase transactions. The act contains provisions for regulating:

1. the format / contents of the hire-purchase agreement
2. warrants and the conditions underlying the hire-purchase agreement,
3. ceiling on hire-purchase charges,
4. rights and obligations of the hirer and the owner.

In absence of any specific law, the hire purchase transactions are governed by the provisions of the Indian Contract Act and the Sale of Goods Act. In chapter relating to leasing we have discussed the provisions related to Indian Contract Act, here we will discuss the provisions of Sale of Goods Act.

SALE OF GOODS ACT:

In a contract of hire purchase, the element of sale is inherent as the hirer always has the option to purchase the movable asset by making regular payment of hire charges and the property in the goods passes to him on payment of the last installment. So in this context we will discuss the provisions of Sales of Goods Act, which apply to hire purchase contract.

Contract of Sale of Goods: A contract of sales of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. It includes both an actual sale and an agreement to sell.

Essential Ingredients of a Sale: A contract of sale is constituted of following elements:

(i) Two parties: namely the buyer and the seller, both competent to contract to effectuate the sale.
(ii) Goods: The subject matter of the contract.
(iii) Money consideration: price of the goods.
(iv) Transfer of ownership: of the general property in goods from the seller to the buyer.
(v) Essentials of a valid contract under the Indian Contract Act.

Sales v/s Bailment: In a sales, there is a conveyance of property in goods from seller to the buyer for a price and the buyer becomes the owner of goods and can deal with them in the manner he likes. In case of bailment (or leasing) there is a mere transfer of possession of goods from the bailor to the bailee.

Sales v/s Mortgage, Pledge and Hypothecation: The essence of contract of a sale is the transfer of general property in the goods. A mortgage is a transfer of interest in the goods from a mortgagor to mortgagee to secure a debt. A pledge is a bailment of goods by one person to another to secure payment of a debt. A hypothecation is an equitable charge on goods without possession, but not amounting to mortgage. The essence and purpose of these contract is to secure a debt. All the three differ from sale, since the ownership in the goods is not transferred which is an essential condition of sale.

Sale v/s hire purchase: A hire purchase agreement is a kind of bailment whereby the owner of the goods lets them on hire to another person called hirer, on payment of certain stipulated periodical payments as hire charges or rent. If the hirer makes payments regularly, he gets an option to purchase the goods on making the full payment. Before this option is exercised, the hirer may return the goods without any obligation to pay the balance rent. The hirer is however, under no compulsion to exercise the option and purchase the goods at the end of the agreement period.

A hire purchase contract, therefore, differs from sale in the sense that:

(i) In a hire purchase the possession of the goods is with the hirer while the ownership vests with the original owner.
(ii) There is no agreement to buy but only an option is given to hirer to buy the goods under certain conditions, and
(iii) The ownership in the goods passes to the hirer when he exercises his option by making the full payment.

Goods: The subject matter of a contract of sale is the 'goods'. 'Goods' mean every kind of movable property excluding money and auctionable claims. Besides, growing crops, standing trees and other things attached to or forming part of land, also fall in the meaning of goods, provided these are agreed to be severed from land before sale or under the contract of sale. Further, stocks, shares, bonds, goodwill, patent, copyright, trademarks, water, gas, electricity, ships and so on are all regarded as goods.

Destruction of goods before making of contract: Where in a contract for sale of specific goods, at the time of making the contract, the goods, without knowledge of the seller, have perished or become so damaged as no longer to answer to their description in the contract, the contract is null and void. This rule, however, does not apply in case of unascertained goods.

Destruction of Goods after the Agreement to sell but before sale: Where in an agreement to sell specific goods, if the goods without any fault on the part of the seller, have perished or become so damaged as no longer answer to their description in the agreement, the agreement becomes void, provided the ownership has not passed to the buyer. If the title to the goods has already passed to the buyer he must pay for the goods though the same cannot be delivered.

Document of Title to goods: A document of title to goods is one which entitles and enables its rightful holder to deal with the goods represented by it, as if he were the owner. It is used in the ordinary course of business as proof of ownership, possession or control of goods, e.g. cash memo, bill of lading, dock warrant, warehouse keeper's or wharfingers certificate, lorry receipt, railway receipt and delivery order.
Price: The price means the money consideration for transfer of property in goods from the seller to the buyer. The price may be ascertained in any of the following modes:

(i) The price may be expressly stated in the contact.
(ii) The price may be left to be fixed in manner provided in the contract.
(iii) Where the price is neither expressed in the contract nor there is any provision for its determination, it may be ascertained by the course of dealings between the parties.
(iv) It may be a 'reasonable price'.
(v) It may be agreed to be fixed by 'third party valuation'.

The most usual mode is however, by expressly providing price in the contract.

EM or security deposit: In certain contract the buyer pays an amount in advance as earnest money deposit or as a security deposit, for the due performance on his part of

the contract. Though the amount of earnest money is adjustable towards the price of the goods, it differs from the price in the sense that while payment towards the prices is recoverable, EM is liable to be forfeited if the buyer fails to perform his part and the contract goes off.

Doctrine of Caveat Emptor (Let the Buyer Beware): If the buyer relies on his own skill and judgment and takes the risk of the suitability of the goods for his purpose, it is no part of the seller's obligation to caution the buyer of the defects in the goods or to give to the buyer an article suitable for his purpose. If the buyer relies on his own skill and judgment and the goods turn out to be defective, he cannot hold the seller responsible for the same.

This is known as the 'doctrine of caveat emptor' or 'let the buyer beware'. This applies to all sale contracts invariably, except in following cases:

a. When the buyer makes known to the seller the particular purpose for which he requires the goods and relies on the seller's skill and judgment.
b. When the goods are sold by description by a manufacturer or seller who deals in goods of that description, the seller is bound to deliver the goods of merchantable quality.
c. When the purpose for which the goods are purchased is implied from the conduct of the parties or from the nature or description of the goods, the condition of quality or fitness for that particular purpose is annexed by the usage of trade.
d. When the seller either fraudulently misrepresents or actively conceals the latent defects.

Transfer of Property in goods: The property in goods is said to be transferred from the seller to the buyer when the latter acquires the proprietary rights over the goods and the obligations linked thereto. The transfer of property in goods is the essence of a contract of sale.

The moment when the property in goods passes from the seller to the buyer is significant from the point that risks associated with the goods follow the ownership, irrespective of the delivery. If the goods are damaged or destroyed, the loss is borne by the person who is the owner of the goods at the time of damage or destruction. The two essential requirements for transfer of property in the goods are

a. Goods must be ascertained and
b. The parties must intend to pass the property in the goods.

Performance of a sale contract: Performance of a sale contract implies, as regards the seller to deliver the goods, and as regards the buyer to accept the delivery and make payment for them, in accordance with the terms of the contract. Unless there is a contract to the contrary, delivery of the goods and payment of the price are concurrent conditions and are to be performed simultaneously.

Delivery of goods: 'Delivery' means 'voluntary transfer of possession of goods from one person to another'. Delivery may be (a) actual (b) symbolic or (c) constructive.

Delivery is said to be actual when the goods are handed over physically. A symbolic delivery takes place where the goods are bulky and incapable of actual delivery e.g. a

car is delivered by handing over the keys to the buyer. A constructive delivery is a delivery by attornment which takes place when the person in possession of the goods acknowledges that he holds the goods on behalf and at the disposal of the other person.

Acceptance of Delivery: The buyer is said to have accepted the goods, when he signifies his assent that he has received the goods under, and in performance of the contract of sale. A buyer cannot reject the goods after he has accepted them. A buyer is deemed to have accepted the goods, when:

(a) He intimates to the seller, his acceptance or
(b) He retains the goods, beyond a reasonable time, without intimating to the seller that he has rejected them or
(c) He does any act in relation to the goods which is consistent with the ownership of the seller.

HIRE PURCHASE AGREEMNT:

A hire purchase agreement is in many ways similar to a lease agreement, in so far as the terms and conditions are concerned. The important clauses in a hire purchase agreement are:

1. Nature of Agreement: Stating the nature, term and commencement of the agreement.
2. Delivery of Equipment: The place and time of delivery and the hirer's liability to bear delivery charges.
3. Location: The place where the equipment shall be kept during the period of hire.
4. Inspection: That the hirer has examined the equipment and is satisfied with it.
5. Repairs: The hirer to obtain at his cost, insurance on the equipment and to hand over the insurance policies to the owner.
6. Alteration: The hirer not to make any alterations, additions and so on to the equipment, without prior consent of the owner.
7. Termination: The events or acts of hirer that would constitute a default eligible to terminate the agreement.
8. Risk: of loss and damages to be borne by the hirer.
9. Registration and fees: The hirer to comply with the relevant laws, obtain registration and bear all requisite fees.
10. Indemnity clause: The clause as per Contract Act, to indemnify the lender.
11. Stamp duty: Clause specifying the stamp duty liability to be borne by the hirer.
12. Schedule: of equipments forming subject matter of agreement.
13. Schedule of hire charges.

The agreement is usually accompanied by a promissory note signed by the hirer for the full amount payable under the agreement including the interest and finance charges.

So far we discussed the legal aspect, let's now discuss the taxation aspect of the hire purchase agreement.

TAXATION ASPECTS:

The taxation aspects of hire purchase transaction can be divided into three parts (a) Income Tax, (b) Sales Tax and (c) Interest Tax.

Income Tax Aspect:

Hire purchase, as a financing alternative, offers tax benefits both to the hire-vendor (hire purchase finance company) and the hirer.

Income tax assessment of the Hire purchase or hirer: The hirer is entitled to (i) The tax shield on depreciation calculated with reference to the cash purchase price and (ii) the tax shield on the finance charges. Even though the hirer is not the owner he gets the benefit of depreciation on the cash price of the asset/equipment. Also he can claim finance charges (difference of hire purchase price and cash price) as expenses. If the agreement provides for the option of purchasing the goods as any time or of returning the same before the total amount is paid, no deduction of tax at source is to be made from the consideration of hire paid to the owner.

Income tax assessment of the Owner or financer: The consideration for hire/hire charges / income received by the hire vendor / financer is liable to tax under the head profits and gains of business and profession where hire purchase constitute the business (mainstream activity) of the assessee, otherwise as income from other sources. The hire income from house property is generally taxed as income from house property. Normal deduction (except depreciation) are allowed while computing the taxable income.

Sales Tax Aspect:

The salient features of sales tax pertaining to hire purchase transactions after the Constitution (Forty Sixth Amendment) Act, 1982, are as discussed in following points:

(a) *Hire purchase as Sale:* Hire purchase, though not sale in the true sense, is deemed to be sale. Such transactions as per se are liable to sales tax. Full tax is payable irrespective of whether the owner gets the full price of the goods or not.
(b) *Delivery v/s Transfer of property:* A hire purchase deal is regarded as a sale immediately the goods are delivered and not on the transfer of the title to the goods. The quantum of sales tax is the sales price, thus the sales tax is charged on the whole amount payable by the hirer to the owner. The sales tax on a hire purchase sale is levied in the state where the hire purchase agreement is executed
(c) *Rate of tax:* The rate of sales tax on hire purchase deals vary from state to state. There is, as a matter of fact, no uniformity even regarding the goods to be taxed. If the rates undergo a change during the currency of a hire purchase agreement, the rate in force on the date of the delivery of the goods to the hirer is applicable.

Interest Tax:

The hire purchase finance companies, like other credit / finance companies, have to pay interest tax under the Interest Tax Act, 1974. According to this Act, interest tax is payable on the total amount of interest earned less bad debts in the previous year at a rate of 2 percent. The tax is treated as a tax deductible expense for the purpose of computing the taxable income under the Income Tax.

LESSON 10
HIRE PURCHASE – ACCOUNTING, REPORTING AND TAXATION

Lesson Objectives: To understand the Concept of Hire Purchase Finance, Regulations related to Hire purchase.

INTRODUCTION:

Hire purchase, as a form of financing, differs from lease financing in one basic respect: while in hire purchase transaction, the hirer has the option to purchase the asset at the end of the period on payment of the last installment of hire charge, the lessee does not have the option to acquire the ownership of the leased asset. A hire purchase transaction has, therefore, some typical features from the point of view of accounting and reporting.

First, although the legal title over the equipment remains with the hire vendor (financer), all risks and rewards associated with the asset stand transferred to the hirer at the inception of the transaction. The accounting implication is that the asset should be recorded in the books of the hirer. The hire-vendor should record them as hire asset stock in trade or as receivables.

Secondly, the hirer should be entitled to the depreciation claim. Finally, the hire charges, like the lease rental in a financial lease, have two components (a) interest charges (b) recovery of principal.

In India, we do not have any accounting guidelines or standards for accounting treatment of hire purchase. There is also no specific law / regulation to govern hire purchase contracts. The aspects which have a bearing on the accounting and reporting of hire purchase deals are the timings of the capitalization of the asset (inception v/s conclusion of the deal), the price, the depreciation charge and the treatment of hire charges.
Now, let us discuss the accounting and reporting treatment of transactions in the books of hirer and financer.
Accounting treatment in the books of hirer:

The cash purchase price of the asset is capitalized and the capital content of the hire purchase installment, that is, the cash purchase price less down payment, if any, is recorded as a liability. The depreciation is based on the cash purchase price of the asset in conformity with the policy regarding similar owned assets. The total charges for credit (unmatured finance charge at the inception of the hire purchase transaction) is allocated over the hire period using one of the several alternative methods, namely, effective rate of interest method, sum of years digits method and straight line method.

Accounting treatment in the books of Hire-vendor (Finance Company):

At the inception of the transaction, the finance company should record the hire purchase installments receivables as current asset (i.e. stock on hire) and the unearned finance income component of these installments as a current liability under the head unmatched finance charges. At the end of each accounting period, an appropriate part of the unmatured finance income should be recognized as current income for the period. It would be allocated over the relevant accounting periods on the basis of any of the following methods (a) ERI (b) SOYD and (c) SLM. At the end of each accounting period, the hire purchase price less the installments received should be shown as receivable / stock on hire and the finance income component of these installment should be shown as current liability / unmatched finance charge. The direct costs associated with structuring the transactions / deal should be either expensed immediately or allocated against the finance income over the hire period.

FINANCIAL EVALUATION:
Now let us discuss the framework of financial evaluation of a hire purchase deal vis-à-vis a finance lease from both the hirer's as well as the finance company's viewpoint.

FROM THE POINT OF VIEW OF THE HIRER (PURCHASER):
The tax treatment given to hire purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire installment. Thus, hire purchase and lease financing represent alternative modes of acquisition of assets. The evaluation of hire purchase transaction from the hirer's angle, therefore, has to be done in relation to leasing alternative.

Decision criterion: The decision criterion from the point of view of hirer is the cost of hire purchase vis a vis the cost of leasing. If the cost of hire purchase is less than the cost of leasing, the hirer should prefer the hire purchase alternative and vice-versa.
Cost of hire purchase: The cost of hire purchase to the hirer consists of the following:

1. Down payment
2. + Service Charges
3. + Present value of hire purchase payments discounted by the cost of debt.
4. – Present value of depreciation tax shield discounted by cot of capital.
5. – Present value of net salvage value discounted by cost of capital.

Cost of leasing: The cost of leasing consists of the following elements:

1. Lease management fee
2. + PV of lease payments discounted by cost of debt.
3. – PV of tax shield on lease payments and lease management fee discounted by cost of capital.
4. + PV of interest tax shield on hire purchase by cost of capital.

FROM THE VIEW POINT OF VENDOR / FINANCER:

Hire purchase and leasing represent two alternative investment decisions of a finance company / financial intermediary / hire-vendor. The decision criterion therefore is based on a comparison of the net present values of the two alternatives, namely, hire purchase and lease financing. The alternative with a higher NPV would be selected and the alternative having a lower NPV would be rejected.

NPV of Hire purchase Plan: The NPV of HPP consist of

1. PV of hire purchase installments
2. + Documentation and service fee.
3. + PV of tax shield on initial direct cost
4. – Loan amount
5. – Initial cost.
6. – PV of interest tax on finance income (interest)
7. – PV of income tax on finance income meted for interest tax
8. – PV of income tax on documentation and service fee.

NPV of Leas Plan: The NPV of LP consists of the following elements:

1. PV of lease rentals.
2. + Leas management fee
3. + PV of tax shield on initial direct costs and depreciation.
4. + PV of Net salvage value.
5. – Initial investment
6. – Initial direct costs.
7. – PV of tax liability on lease rentals and lease management fee.

Hire Purchase FAQ's

1. What is Hire Purchase?

It is a transaction by which a person buys a movable asset and pays the sale consideration to the financier in installments. It is an agreement of hire with an option to the hirer to purchase the asset. He is allowed to use the asset immediately, but becomes its owner only after he exercises the option after paying the entire installments. So in effect, he takes a loan from the owner or financier. During the repayment period the ownership remains with the financier.

2. What is ‘option to purchase’?

In a hire purchase agreement, at the end of the hire period when all hire charges have been paid, the hirer has the option to purchase the asset at a value fixed by the financier. This is known as the option to purchase.

3. What are the kinds of assets purchased under a hire purchase agreement?

Movable assets like cars, machinery, fixtures and furniture, computers and electronic items, that can be delivered physically, can be purchased. Immovable property cannot be purchased under a hire purchase agreement. The transaction with reference to immovable property is normally referred to as sale and lease agreement.

4. Is a guarantor required in a Hire purchase agreement and if so who can be a guarantor?

A guarantor is not essential for a hire purchase transaction, unless the financier insists on it. Most financiers however insist on a guarantor. The guarantor acts as an additional security against default in payment by the hirer. Any creditworthy person

can be a guarantor, if the financier is satisfied that he can repay the money in case of default by the hirer.

5. What is the financier's security in a Hire purchase agreement, without a guarantor?

The financier may ask the hirer for an immovable property as security. However the primary security for the financier is the product purchased under the agreement.

6. What precautions should a hirer take before he enters into a hire purchase agreement?

Before entering into a hire-purchase agreement, a person should 1.Sign on a hire purchase agreement form containing the terms of hire purchase. 2. Insist for a copy of the agreement for his record. 3. Keep a record of all payments made to the financier till the payment of the last installment. 4. Get a 'no dues' receipt from the financier after full payment of the hire purchase charges.

7. Can I pre-pay all my installments under hire purchase agreement?

Normally a financier does not allow any pre-payment of installments unless he is compensated for the loss of interest.

8. Will default or delay in the payment of installments attract penalty?

Yes. Usually, the hirer has to pay a penalty or fine to the financier for default or delay in the payment of the dues under the agreement.

9. What are the income tax implications in the case of a hire purchase?

In the hire purchase the hirer carrying business or profession gets benefit of depreciation. He can also claim deduction on the interest paid on hire charges, in his income tax assessment.

Hire purchase: taking the customer to court

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Under modern hire purchase agreements, the hirers are simply paying for the use of the goods and for the option to buy them

Though hire purchase agreements are very common while buying consumer goods, there is no specific law that caters to the needs of the modern times. Parliament passed the Hire Purchase Act in 1972, but it is a classic case of neglect.

It has not been notified in the official gazette in three decades. Therefore it has no force of law. As a result, hire purchase agreements are covered by the law of contract and the interpretation given by the courts to the agreements.

Many of those who rush to buy motor vehicles and other goods realise the rigours of the contract only when the re-possessors arrive. But then it is too late, as the Supreme Court judgement last week in Charanjit Singh vs Sudhir Mehra showed. Even in law, it is a lost battle for the buyer.

In this case, Sudhir bought a motor vehicle under a hire purchase agreement with a non-banking financial institution. When the instalment stopped, the financier forcibly took away the vehicle from the motor mechanic where it was given for repairs.

The purchaser filed a criminal complaint against the financier for theft, cheating and criminal breach of trust. The financier moved the Punjab high court for quashing the complaint. The high court dismissed it. So it moved the Supreme Court which quashed the complaint after finding fault with the high court view.

The problem arises because most of those who go in for hire purchase agreements do not understand the nature of the contract. The deed is also deliberately made bulky by the financier so that an ordinary buyer would not take time to read the terms.
Even if they try to read it, the legalese would put off even the educated. If you ask for your copy of the agreement after signing on the dotted lines till your fingers ache, there would be evasive answers. Thus it is a losing battle from the start.

Hire purchase agreements were originally entered into between the dealer and the customer and the dealer used to extend credit to the customer. But as hire purchase gained popularity, the dealers could not expand the working capital. Then the financier came into the picture. The finance company would buy the goods from the dealer and let them to the customer under the hire purchase agreement.
The dealer would deliver the goods to the buyer and then drop out of the transaction, leaving the finance company to collect the instalments directly from the customer.

Under modern hire purchase agreements, the hirers are simply paying for the use of the goods and for the option to buy them. The finance charge, representing the difference between the cash price and the hire purchase price, is not interest but represents a sum which the hirer has to pay for the privilege of being allowed to discharge the purchase price of goods in instalments.
In this case, the small print gave the financier the right to "enter any building, premises or place where the vehicle may be kept for inspection, re-possession or attempt to re-possess".

It further emphasised that such attempts will not make the financier liable for any civil or criminal action at the instance of the hirer. Therefore, even if a case is filed against the financier for dacoity in such circumstances (as in Sardar Trilok Singh vs Satya Deo, 1979), the financier will have the upper hand. The Supreme Court, in Damodar Valley Corporation v/s State of Bihar has discussed different types of agreements in the nature of hire purchase. These and other judgements make tedious reading.
What is required now is a comprehensive legislation taking into consideration the needs of the consumerist era. The law-makers who have neglected to notify the 1972 Act must now start working on a new legislation on the subject.

LESSON 11
COMPARATIVE STUDY OF VARIOUS FORMS OF CREDIT

Lesson Objectives:	To understand the various forms of customer credit and their comparative study. Develop an understanding, so that financing offers can be best evaluated.

Dear Students, so far you have studied various forms of financing options. After studying in detail various forms of consumer credit / financing options, it becomes essential to make their comparative study and evaluation of each with respect to other, so you get an objective idea that which form of credit is best suited for which situation.

You all have to submit a write up on comparative advantages and disadvantages of various forms of credit, namely: Leasing, Hire Purchase, Installment payment and term loan.

Your faculty will provide you a case study, for discussion in the class based on various forms of credit.

LESSON 12
FACTORING – THEORETICAL FRAMEWORK

Lesson Objectives:	To understand the Concept of Factoring.
	Methodology of Factoring and Forfeiting.
	Types of factoring.

INTRODUCTION:

Receivables constitute a significant portion of current assets of a firm. But, for investment in receivables, a firm has to incur certain costs such as costs of financing receivables and costs of collection from receivables. Further, there is a risk of bad debts also. It is, therefore, very essential to have a proper control and management of receivables. In fact, maintaining of receivables poses two types of problems; (i) the problem of raising funds to finance the receivables, and (it) the problems relating to collection, delays and defaults of the receivables. A small firm' may handle the problem of receivables management of its own, but it may not be possible for a large firm to do so efficiently as it may be exposed to the risk of more and more bad debts. In such a case, a firm may avail the services of specialised institutions engaged in receivables management, called factoring firms.

At the instance of RBI a Committee headed by Shri C. S. Kalyan Sundaram went into the aspects of factoring services in India in 1988, which formed the basis for introduction of factoring services in India. SBI established, in 1991, a subsidiary-SBI Factors Limited with an authorized capital of Rs. 25 crores to undertake factoring services covering the western zone

MEANING AND DEFINITION

Factoring may broadly be defined as the relationship, created by an agreement, between the seller of goods/services and a financial institution called .the factor, whereby the later purchases the receivables of the former and also controls and administers the receivables of the former.

Factoring may also be defined as a continuous relationship between financial institution (the factor) and a business concern selling goods and/or providing service (the client) to a trade customer on an open account basis, whereby the factor purchases the client's book debts (account receivables) with or without recourse to the client - thereby controlling the credit extended to the customer and also undertaking to administer the sales ledgers relevant to the transaction.

The term" factoring" has been defined in various countries in different ways due to non-availability of any uniform codified law. The study group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended, in simple words, the definition of factoring as under:

"Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor:

- Finance

- Maintenance of accounts
- Collection of debts
- Protection against credit risks".

The above definition, however, applies only to factoring in relation to supply of goods and services in respect of the following:

(i) To trade or professional debtors
(ii) Across national boundaries
(iii) When notice of assignment has been given to the debtors.

The development of factoring concept in various developed countries of the world has led to some consensus towards defining the term. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/services are sold to the "factor" as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Hence the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer (s).

GLOSSARY OF TERMINOLOGY

The common terminology used in a factoring transaction are as follows:

(i) *Client* He is also known as supplier. It may be a business institution supplying the goods/services on credit and availing of the factoring arrangements.
(ii) *Customer* A person or business organisation to whom the goods/ services have been supplied on credit. He may also be called as debtor.
(iii) *Account receivables* Any trade debt arising from the sale of goods/ services by the client to the customer on credit.
(iv) *Open account sales* Where in an arrangement goods/services are sold/supplied by the client to the customer on credit without raising any bill of exchange or promissory note.
(v) *Eligible debt* Debts, which are approved by the factor for making prepayment.
(vi) *Retention* Margin maintained by the factor.
(vii) *Prepayment* An advance payment made by the factor to the client up to a certain percent of the eligible debts.

NATURE OF FACTORING

Factoring is a tool of receivable management employed to release funds tied up in credit extended to customers.

1. Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverable and other credit dues resulting from credit sales appear in the books of account as book credits.
2. The risk associated with credit are taken over by the factor which purchases these credit receivables without recourse and collects them when due.
3. A factor performs at least two of the following functions:
    (i) Provides finance for the supplier including loans and advance payments.
    (ii) Maintains accounts, ledgers relating to receivables.

(iii) Collects receivables.
(iv) Protects risk of default in payments by debtors.

4. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales. It acts as another financial intermediary between the buyer and seller.
5. Unlike a bank, a factor specialises in handling and collecting receivables in an efficient manner. Payments are received by the factor directly since the invoices are assigned in favor of the factor.
6. Factor is responsible for sales accounting, debt collection and credit control protection from bad debts, and rendering of advisory services to their clients.
7. Factoring is a tool of receivables management employed to release funds tied up in credit extended to customers and to solve the problems relating to collection, delays and defaults of the receivables.

MECHANISM OF FACTORING

Factoring business is generated by credit sales in the normal course business. The main function of factor is realisation of sales. Once the transaction takes place, the role of factor step in to realise the sales/collect receivables. Thus, factor act as a intermediary between the seller and till and sometimes along with the seller's bank together.

The mechanism of factoring is summed up as below:

(i) An agreement is entered into between the selling firm and the firm. The agreement provides the basis and the scope understanding reached between the two for rendering factor service.
(ii) The sales documents should contain the instructions to make payment directly to the factor who is assigned the job of collection of receivables.
(iii) When the payment is received by the factor, the account of the firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.
(iv) The factor may provide advance finance to the selling firm conditions of the agreement so require.

PARTIES TO THE FACTORING

There are basically three parties involved in a factoring transaction.

1. The buyer of the goods.
2. The seller of the goods
3. The factor i.e. financial institution.

The three parties interact with each other during the purchase/sale of goods. The possible procedure that may be followed is summarised below.

The Buyer

(1) The buyer enters into an agreement with the seller and negotiates the terms and conditions for the purchase of goods on credit.
(2) He takes the delivery of goods along with the invoice bill and instructions from the seller to make payment to the factor on due date.
(3) Buyer will make the payment to the factor in time or ask for extension of time. In case of default in payment on due date, he faces legal action at the hands of factor.

The Seller

(1) The seller enters into contract for the sale of goods on credit as per the purchase order sent by the buyer stating various terms and conditions.
(2) Sells goods to the buyer as per the contract.
(3) Sends copies of invoice, delivery challan along with the goods to the buyer and gives instructions to the buyer to make payment on due date.
(4) The seller sells the receivables received from the buyer to a factor and receives 80% or more payment in advance.
(5) The seller receives the balance payment from the factor after paying the service charges.

The Factor

1) The factor enters into an agreement with the seller for rendering factor services i.e. collection of receivables/debts.
2) The factor pays 80% or more of the amount of receivables copies of sale documents.
3) The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges.

TYPES OF FACTORING

A number of factoring arrangements are possible depending upon the agreement reached between the selling firm and the factor. The most common feature of practically all the factoring transactions is collection of receivables and administration of sale ledger. However, following are some of the important types of factoring arrangements.

1. Recourse and Non-recourse Factoring

In a recourse factoring arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad, Let the risk of bad debts is to be borne by the client and the factor does not assume credit risks associated with the receivables. Thus the factor acts as an agent for collection of bills and does not cover the risk of customer's failure to pay debt or interest on it. The factor has a right to recover the funds from the seller client in case of such defaults as the seller takes the risk of credit and creditworthiness of buyer. The factor charges the selling firm for maintaining the sales ledger and debt collection services and also charges interest on the amount drawn by the client (selling firm) for the period.

Whereas, in case of non-recourse factoring, the risk or loss on account of non-payment by the customers of the client is to be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non-payment, commission or fees charged for the services in case of non-recourse factoring is higher than under the recourse factoring. The additional fee charged by the factor for bearing the risk of bad debts/non-payment on maturity is called *del credere* commission.

2. Advance and Maturity Factoring

Under advance factoring arrangement, the factor pays only a certain percentage (between 75 % to 90 %) of the receivables in advance to the client, the balance being paid on the guaranteed payment date. As soon as factored receivables are approved, the advance amount is made available to the client by the factor. The factor charges discount/interest on the advance payment from the date of such payment to the date of

actual collection of receivables by the factor. The rate of discount/interest is determined on the basis of the creditworthiness of the client, volume of sales and prevailing short-term rate.

Sometimes, banks also participate in factoring transactions. A bank agrees to provide an advance to the client to finance a part say 50% of the (factored receivables - advance given by the factor). For example :

Assume total value of the factored debt/receivable is	Rs. 100
A factor finances 80 % of the debt.	Rs. 80
Balance value of debt	Rs. 20
Say, bank finances 50% of the balance i.e.	Rs. 10.

Thus, the factor and the bank will make a pre-payment of Rs. 90 (i.e. 90% of the debt) and the client's share is only 10% of the investment in receivables. In case of maturity factoring, no advance is paid to client and the payment is made to the client only on collection of receivables or the guaranteed payment data as the case may be agreed between the parties. Thus, maturity factoring consists of the sale of accounts receivables to a factor with no payment of advance funds at the time of sale.

3. Conventional or Full Factoring

Under this system the factor performs almost all services of collection of receivables, maintenance of sales ledger, credit collection, credit control and credit insurance. The factor also fixes up a draw limit based on the bills outstanding maturity-wise and takes the corresponding risk of default or credit risk and the factor will have claims on the debtor as also the client creditor.

It is also known as Old Line Factoring. Number of other variety of services such as maturity-wise bills collection, maintenance of accounts, advance granting of limits to a limited discounting of invoices on a selective basis are provided. In advanced countries, all these methods are popular but in India only a beginning has been made. Factoring agencies like SBI Factors are doing full factoring for good companies with recourse.

4. Domestic and Export Factoring

The basic difference between the domestic and export factoring is on account of the number of parties involved. In the domestic factoring three parties are involved, namely:

The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language.

1) Customer (buyer)
2) Client (seller)
3) Factor (financial intermediary)

All the three parties reside in the same country. Export factoring is also termed as cross-border/international factoring and is almost similar to domestic factoring except that there are four parties to the factoring transaction. Namely, the exporter (selling firm or client), the importer or the customer, the export factor and the import factor. Since, two factors are involved in the export factoring, it is also called two-factor system of factoring.

Two factor system results in two separate but inter-related contracts:

1) between the exporter (client) and the export factor.

2) export factor and import factor.

The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language. He also assumes customer trade credit risk, and agrees to collect receivables and transfer funds to the export factor in the currency of the invoice. Export/International factoring provides a non-recourse factoring deal. The exporter has 100 % protection against bad debts loss arising on account of credit sales.

5. Limited Factoring

Under limited factoring, the factor discounts only certain invoices on selective basis and converts credit bills into cash in respect of those bills only.

6. Selected Seller Based Factoring

The seller sells all his accounts receivables to the factor along with invoice delivery challans, contracts etc. after invoicing the customers. The factor performs all functions of maintaining the accounts, collecting the debts, sending reminders to the buyers and do all consequential and incidental functions for the seller. The sellers are normally approved by the factor before entering into factoring agreement.

7. Selected Buyer Based Factoring

The factor first of all selects the buyers on the basis of their goodwill and creditworthiness and prepares an approved list of them. The approved buyers of a company approach the factor for discounting their purchases of bills receivables drawn in the favour of the company in question (i.e. seller). The factor discounts the bills without recourse to seller and makes the payment to the seller.

8. Disclosed and Undisclosed Factoring

In disclosed factoring, the name of the factor is mentioned in the invoice by the supplier telling the buyer to make payment to the factor on due date. However, the supplier may continue to bear the risk of bad debts (i.e. non-payments) without passing to the factor. The factor assumes the risk only under non-recourse factoring agreements. Generally, the factor lays down a limit within which it will work as a non-recourse. Beyond this limit the dealings are done on recourse basis i.e. the seller bears the risk.

Under undisclosed factoring, the name of the factor is not disclosed in the invoice. But still the control lies with the factor. The factor maintain sales ledger of the seller of goods, provides short-term finance against the sales invoices but the entire transactions take place in the name of the supplier company (seller).

FUNCTIONS OF A FACTOR

The purchase of book debts or receivables is central to the function of factoring permitting the factor to provide basic services such as :

1. Administration of sellers' sales ledger.
2. Collection of receivables purchased.
3. Provision of finance.
4. Protection against risk of bad debts/credit control and credit protection.
5. Rendering advisory services by virtue of their experience in financial dealings with customers.

These are explained as under.

1. Administration of Sales Ledger

The factor assumes the entire responsibility of administering sales ledger. The factor maintains sales ledger in respect of each client. When the sales transaction takes place, an invoice is prepared in duplicate by the client, one copy is given to customer and second copy is sent to the factor. Entries are made in the ledger on open-item method. Each receipt is matched against the specific invoice. On any given date, the customer account indicates the various open invoices outstanding. Periodic reports are sent by factor to the client with respect to current status of receivables and amount received from customers. Depending upon the volume of transactions, the periodicity of report is decided. Thus, the entire sales ledger administration responsibility of the client gets transferred to the factor. He performs the following functions with regard to the administration of sales ledger:

(i) He ensures that invoices raised represent genuine trade transactions in respect of goods sold or services provided.

(ii) He updates the sales ledger with latest invoices raised and cash received.

(iii) He ensures that monthly statements are sent to the debtors, efforts are made to collect the dues on the due dates through an efficient mechanism of personal contacts, issuance of reminders, telephone messages etc.

(iv) He remits the retention to the clients after collection of the dues. Where the factoring is operating on Fixed Maturity Period (FMP) basis, the factor is to ensure that the client is paid the retention money at the expiry of the said period.

(v) He establishes close links with the client and the customers to resolve the various disputes raised in respect of quantity or quality of the goods/services supplied besides the unauthorised discounts claimed or deducted by the debtors while making payment.

(vi) He reviews the financial strength of the debtors at periodic intervals to ensure collectability of debts.

(vii) He submits at periodic intervals the reports containing information as to the details of overdue unpaid invoices, disputes, legal cases etc. to the client.

2. Collection of Receivables

The factor helps the client in adopting better credit control policy. The main functions of a factor is to collect the receivables on behalf of the client and to relieve him from all the botherations/problems associated with the collection. This way the client can concentrate on other major areas of his business on one hand and reduce the cost of collection by way of savings in labor, time and efforts on the other hand. The factor possesses trained and experienced personnel, sophisticated infrastructure and improved technology which helps him to make timely demands on the debtors to make payments.

3. Provision of Finance

Finance, which is the lifeblood of a business, is made available easily by the factor to the client. A factor purchases the book debts of his client and debts are assigned in favor of the factor. 75% to 80 percent of the assigned debts is given as an advance to the client by the factor.

(a) Where an agreement is entered into between the client (seller) and the c factor for the purchase of receivables without recourse, the factor becomes responsible to the seller on the due date of the invoice whether or not the buyer makes the payment to the factor.

(b) Where the debts are factored with recourse- the client has to refund the full finance amount provided by the factor in case the buyer fails to make the payment on due date.

4. Protection Against Risk

This service is provided where the debts are factored without recourse. The factor fixes the credit limits (i.e. the limit up to which the client can sell goods to customers) in respect of approved customers. Within these limits the factor undertakes to purchase all trade debts and assumes risk of default in payment by the customers. The factor not only relieves the client from the collection work but also advises the client on the creditworthiness of potential customers. Thus the factor helps the client in adopting better credit control policy. The credit standing of the customer is assessed by the factors on the basis of information collected from credit rating reports, bank reports, trade reference, financial statement analysis and by calculating the important ratios in respect of liquidity and profitability position.

5. Advisory Services

These services arise out of the close relationship between a factor and a client. Since the factors have better knowledge and wide experience in field of finance, and possess extensive credit information about customer's standing, they provide various advisory services on the matters relating to :

(a) Customer's preferences regarding the clients products.
(b) Changes in marketing policies/strategies of the competitors.
(c) Suggest improvements in the procedures adopted for invoicing, delivery and sales return.
(d) Helping the client for raising finance from banks/financial institutions, etc.

The factor provides his client with a periodical statement on the sanctioned limit, utilised credit and balance outstanding. The following data is provided regularly:

(a) List of book debts taken over
(b) Book debts realised
(c) Age-wise classification of the debts
(d) Debts collected and due for collection
(e) Debts purchased with recourse or without recourse etc.

COST OF SERVICES

The factor provides various services at some charge in the form of a commission expressed as a value of debt purchased. It is collected in advance. The commission is in the form of interest charged for the period between the date of advance payment and date of collection/guarantee payment date for short term financing as advance part payment. It is also known as discount charge.

The cost of factoring services primarily comprises of the following two components:

1. Administrative charges /factoring fees

This is charged towards providing various services to the clients namely (a) sales ledger administration (b) credit control including processing, operational overheads and collection of debts (c) providing, protection against bad debts.

This charge is usually some percent of the projected sales turnover of the client for the next twelve months. It varies between 1 to 2.5 percent of the projected turnover. The quantum of charged depends upon the following factors.

a) Type of industry

b) Financial strength of the client as well as of the debtors
c) Volume of sales
d) Average invoice value
e) Terms of trade
f) Type(s) of service(s) offered
g) Required profit margin to the factor
h) Extent of competition
i) Security to the factor etc.

2. Discount charges

This is levied towards providing instant credit to the client by way of prepayment. This is normally linked with the base rate of the parent company or the bank from which the factoring institution is borrowing money, say, 1 to 2.5 percent above the said rate.

IMPACT ON BALANCE SHEET

Factoring, as a financial service has a positive impact on the Balance Sheet as can be illustrated with the help of an example:

BALANCE SHEET: PRE-FACTORING POSITION

(Rs. crores)

Current Liabilities (CL)		Current Assets (CA)	
Bank borrowing against		Inventory	100
(i) Inventory	70	Receivables	80
(ii) Receivables	50	Other current assets	20
	120		
Other current liabilities	30		
	150		
Net Working Capital (CA-CL)	50		
Total Current Liabilities			
200	Total Current Assets		
	200		

Original Current Ratio 1:33: 1 (200 : 150)

The requirement of net working capital is Rs. 50 crores (Current Assets - Current Liabilities). As the borrower carries other current liabilities to the extent of Rs. 30 crores he is eligible for a maximum bank borrowing of Rs. 120 crores divided into cash credit limit of Rs. 70 crores against inventory and Rs.50 crores against receivables, taking into account the stipulated margins for inventory and receivables and also the proportion of individual levels of inventory of Rs. 100 crores and receivables of Rs. 80 crores.

On the basis of above data, the borrower is eligible for working capital limits aggregating Rs. 120 crore under the second method of: lending as recommended by the Tondon Committee. ,

Assume the borrower decides to factor his debts. The Receivables aggregating Rs. 80 crore are purchased by a factor who in turn makes advance payment of 80% i.e. Rs. 64 crore. He retains Rs. 16 crore (factor reserve) which will be repaid on payment by the customer.,

BALANCE SHEET: POST-FACTORING POSITION

(Rs. Crore)

Current Liabilities (CL)		Current Assets (CA)	
Bank: borrowing against		Inventory	100
Inventory	70	Receivables (Due from factor)	16
Other current liaoilities	16	Other current assets	20
Net working capital	50		
(CA;-CL)	136		136

New Current Ratio 1.581: r-(136 : 86)

The impact of factoring on balance sheet may be stated in terms of :

1. *Improvement in Current Ratio*. The current ratio improves from 1.33: 1 (before factoring) to 1.58 : 1. The new current ratio is better for the client and his credit rating goes up before public eye.

2. *Reduction in Current Liabilities*. An advance payment of Rs. 64 crores (i.e. 80% of 80 crore) is utilised in repaying the bank borrowings against receivables to the tune of Rs. 50 crores and for meeting other current liabilities to the tune of Rs. 14 crores. The net effect of factoring transaction is that the current liabilities get reduced by Rs. 64 crore.

3. *Off-Balance Sheet Finance*. Since the client's debts are purchased by the factor and amount is paid to the client, it serves as off the balance sheet finance and appears in the balance sheet only as a contingent liability in the case of recourse factoring. Because in case of default by the buyer, the client will have to refund the finance amount to the factor. But in case of non-recourse factoring, it does not appear anywhere in the financial statement of the borrower.

Thus factoring services help the client to improve the structure of balance sheet.

ADVANTAGES OF FACTORING

Factoring is becoming popular all over the world on account of various services offered by the institutions engaged in it. Factors render services ranging from bill discounting facilities offered by the commercial banks to total take over of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control, protection from bad debts, provision of finance and rendering of advisory services to their clients. Thus factoring is a tool of receivables management employed to release the funds tied up in credit extended to customers and to solve problems relating to collection, delays and defaults of the receivables.

A firm that enters into factoring agreement is benefited in a number of ways, some of the important benefits are outlined below:

(1) The factors provides specialised services with regard to sales ledger administration and credit control and relieves the client from the botheration of debt collection. He can concentrate on the other major areas of his business and improve his efficiency.

(2) The advance payments made by the factor to the client in respect of the bills purchased increase his liquid resources. He is able to meet his liabilities as and when they arise thus improving his credit standing position before suppliers, lenders and bankers. The factor's assumption of credit risk relieves him from the tension of bad debt losses. The client can take steps to reduce his reserve for bad debts.

(3) It provides flexibility to the company to decide about extending better terms to their customers.
(4) The company itself is in a better position to meet its commitments more promptly due to improved cash flows.
(5) Enables the company to meet seasonal demands for cash whenever required.
(6) Better purchase planning is possible. Availability of cash helps the company to avail cash discounts on its purchases.
(7) As it is an off balance sheet finance, thus it does not affect the financial structure. This would help in boosting the efficiency ratios such as return on asset etc.
(8) Saves the management time and effort in collecting the receivables and in sales ledger management.
(9) Where credit information is also provided by the factor, it helps the company to avoid bad debts.
(10) It ensures better management of receivables as factor firm is specialised agency for the same. The factor carries out assessment of the client with regard to his financial, operational and managerial capabilities whether his debts are collectable and viability of his operations. He also assesses the debtor regarding the nature of business, vulnerability of his operations; and assesses the debtor regarding the nature of business, vulnerability to seasonality, history of operations, the term of sales, the track record and bank report available on the past history.

LIMITATIONS

The above listed advantages do not mean that the factoring operations are totally free from any limitation. The attendant risk itself is of very high degree. Some of the main limitations of such transactions are listed below:

(1) It may lead to over-confidence in the behavior of the client resulting in over-trading or mismanagement.
(2) The risk element in factoring gets accentuated due to possible fraudulent acts by the client in furnishing the main instrument "invoice" to the factor. Invoicing against non-existent goods, pre-invoicing (i.e. invoicing before physical dispatch of goods), duplicate-invoicing (i.e. making more than one invoice in respect of single transaction) are some commonly found frauds in such operations, which had put many factors into difficulty in late 50's all over the world.
(3) Lack of professionalism and competence, underdeveloped expertise, resistance to change etc. are some of the problems which have made factoring services unpopular.
(4) Rights of the factor resulting from purchase of trade debts are uncertain, not as strong as that in bills of exchange and are subject to settlement of discounts, returns and allowances.
(5) Small companies with lesser turnover, companies having high concentration on a few debtors, companies with speculative business, companies selling a large number of products of various types to general public or companies having large number of debtors for small amounts etc. may not be suitable for entering into factoring contracts.

LESSON 13
FACTORING AND FORFEITING – FINANCIAL EVALUATION

Lesson Objectives:	Study Financial Evaluation of Factoring.
	Understand Concept of Forfeiting.
	Position of Factoring & Forfeiting in India.

COST-BENEFIT ANALYSIS OF FACTORING (FINANCIAL EVALUATION)

The cost-benefit analysis of factoring is concerned with comparing of costs and benefits associated with factoring. A firm would prefer to have factoring arrangements if the risk of default or non-payment is high and the cost involved by way of fees and service charges of the factor are less than the benefits associated with the same. The following examples illustrate the financial evaluation of factoring.

Example 1. Bharat Ltd. decides to liberalise credit to increase its sales. The liberalised credit policy will bring additional sales of Rs. 3,00,000. The variable costs will be 60 % of sales and. there will be 10% risk for non-payment and 5 % collection costs. Will the company benefit from the new credit policy?

Solution.

Additional Sales Revenue	Rs. 3,00,000
Less: Variables Cost (60%) Incremental Revenue	180000
Incremental Revenue	120000
Less: 10% for non-payment risk	30000
	90000
Less 5% for costs of collection	15000
Additional Revenue from increased sales due to liberal credit policy	75000

FACTORING V/ S BILL DISCOUNTING

In addition to the rendering of factoring services, banks and financial institutions also provide bills discounting facilities to provide finance to the client.

Following are the similarities and differences between the two services.

Dissimilarities/Differences

The two services differ from each other in the following respects:

Bills Discounting	Factoring
1. It is a provision of finance against bills. 2. Advances are made against the bills 3. The drawer undertakes the responsibility of collecting the bills and remitting the proceeds to financing agency. 4. Bills discounted may be rediscounted several times before the maturity 5. Bill discounting is always with recourse, i.e. in case of default the client will have to make good the loss. 6. Bill financing is individual transaction oriented i.e. each bill is separately assessed on its merits and got discounted purchased. 7. Bill finance is always 'In Balance Sheet' financing i.e. both the amounts of receivables and bank credit are reflected in the balance sheet of the clients as current assets and current liabilities respectively. This is because of the 'with recourse' nature of the facility. 8. The drawee or the acceptor of the bills is in full knowledge of the bank's charge on the receivables arising from the sale of goods and services.	1. Factoring renders all services like maintenance of sales ledger, advisory services, etc in addition to the provision of finance. 2. Trade debts are purchased by assignment. 3. Factoring undertakes to collect the bills of the client. 4. Debts purchased for factoring cannot be rediscounted, they can only be refinanced 5. Factoring may be with or without recourse. 6. Whereas in factoring, bulk is provided against several unpaid trade generated invoices in batches. It follows the principle of 'whole turnover' 7. In full factoring services facility is 'off balance sheet' arrangement, as the client company completes his double entry accounting by crediting the factor for consideration value. 8. Factoring services like 'undisclosed factoring' are confidential in nature i.e. the debtors are not aware of the arrangements. Thus, the large industrial houses availing such facility can successfully claim of running business of their own without any outside financial support.

Similarities

(1) Both provide short-term finance.

(2) Both get the account receivables discounted which the client would have otherwise received from the buyer at the end of credit period.

FORFAITING

The forfaiting owes its origin to a French term 'a forfait' which means to forfeit (or surrender) ones' rights on something to some one else. Forfaiting is a mechanism of financing exports:

(a) by discounting export receivables

(b) evidenced by bills of exchanges or promissory notes

(c) without recourse to the seller (viz; exporter)

(d) carrying medium to long-term maturities

(e) on a fixed rate basis upto 100% of the contract value.

In other words, it is trade finance extended by a forfaiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount. Forfaiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms. Recourse to forfaiting usually takes place where the credit is for long date maturities and there is no prohibition for extending the facility where the credits are maturing in periods less than one year.

Parties to forfaiting

There are five parties in a transaction of forfaiting. These are

(i) Exporter

(ii) Importer

(iii) Exporter's bank

(iv) Importer's bank

(v) the forfaiter.

Mechanism

1. The exporter and importer negotiate the proposed export sale contract. Then the exporter approaches the forfaiter to ascertain the terms of forfaiting.
2. The forfaiter collects details about the importer, supply and credit terms, documentation etc.
3. Forfaiter ascertains the country risk and credit risk involved.
4. The forfaiter quotes the discount rate.
5. The exporter then quotes a contract price to the overseas buyer by loading the discount rate, commitment fee etc. on the sale price of the goods to be exported.
6. The exporter and forfaiter sign a contract.
7. Export takes place against documents guaranteed by the importer's bank.
8. The exporter discounts the bill with the forfaiter and the latter presents the same to the importer for payment on due date or even sell it in secondary market.

Documentation

1. Forfaiting transaction is usually covered either by a promissory note or bills of exchange.
2. Transactions are guaranteed by a bank.

3. Bills of exchange may be 'availed by' the importer's bank. 'Aval' is an endorsement made on bills of exchange or promissory note by the guaranteeing bank by writing 'per aval' on these documents under proper authentication.

Costs of forfaiting

The forfaiting transaction has typically three cost elements:

1. Commitment fee, payable by the exporter to the forfaiter 'for latter's' commitment to execute a specific forfaiting transaction at a firm discount rate with in a specified time.
2. Discount fee, interest payable by the exporter for the entire period of credit involved and deducted by the forfaiter from the amount paid to the exporter against the availised promissory notes or bills of exchange.
3. Documentation fee.

Benefits of forfaiting

Forfaiting helps the exporter in the following ways:

1. It frees the exporter from political or commercial risks from abroad.
2. Forfaiting offers 'without recourse' finance to an exporter. It does not effect the exporter's borrowing limits/capacity.
3. Forfaiting relieves the exporter from botheration of credit administration and collection problems.
4. Forfaiting is specific to a transaction. It does not require long term banking relationship with forfaiter.
5. Exporter saves money on insurance costs because forfaiting eliminates the need for export credit insurance.

Problem areas in forfaiting and factoring where legislation is required.

1. There is, presently, no legal framework to protect the banker or forfaiter except the existing covers for the risks involved in any foreign transactions.
2. Data available on credit rating agencies or importer or foreign country is not sufficient. Even exim bank does not cover high-risk countries like Nigeria.
3. High country and political risks dissuade the services of factoring and banking to many clients.
4. Government agencies and public sector undertakings (PSUs) neither promptly make payments nor pay interest on delayed payments.
5. The assignment of book debts attracts heavy stamp duty and this has to be waived.
6. Legislation is required to make assignment under factoring have priority over other assignments.
7. There should be some provisions in law to exempt factoring organization from the provisions of money lending legislations.
8. The order 37 of Civil procedure code should be amended to clarify that factor debts can be recovered by resorting to summary procedures.

Thus, the existing legal framework governing the transactions of factoring business is not adequate to make the functioning simple, inexpensive and attractive in the market. In order to ensure that the functioning of a factor is with ease and confidence the legal framework should:

(a) define the rights, liabilities, duties and obligations of the parties involved, in a clear and comprehensive manner, so that the parties can plan their affairs with certainty, and

(b) be supportive of the transactions and procedures involved, so that they may be undertaken and completed simply and inexpensively.

In short, areas like 'assignment', 'stamp duty', 'priorities of factoring assignment', 'liabilities of the debtor', 'obligations of banks', realisation of debts through simple legal process etc. require focused attention. A draft bill on the factoring of debts due to industrial and commercial undertakings has been prepared which awaits clearance by the Government of India. Once this bill is passed majority of the constraints will be eliminated.

FACTORING IN INDIA

Banks do provide non-banking financial services such as housing finance, leasing and hire-purchase, factoring and forfaiting. An amendment was made in the Banking Regulation Act in 1983, whereby banks were permitted to provide these services either through their own departments or divisions or through their subsidiaries. Direct and indirect lending services were provided by setting up merchant banking and mutual funds subsidiaries. Factoring and forfaiting services were of recent origin following the recommendation of the Kalyansundarm Committee, set up by the RBI in 1988.

The Committee was constituted to examine the feasibility of factoring services in India, their constitution, organisational setup and scope of activities. The group recommended setting up of specified agencies or subsidiaries for providing the factoring services in India.

While attempting to assess the potential demand for factoring services in India, the study group under the leadership of Mr. C. S. Kalyansundram estimated the value of outstanding open account credit sales available for financing during 1989-90 at Rs. 12,000 crores in respect of SSI and Rs. 4500 crores for medium and large scale sector. Assuming only 50% of the above business will be available for factoring, the aggregate potential demand for factoring was expected to be around Rs. 4000 crores per annum mainly emerging from the SSI and large and medium companies.

Major Players

The first factoring company was started by the SBI in 1991 namely Factors and Commercial Ltd. (SBI FACS) followed by Canara Bank and PNB, setting the subsidiaries for the purpose. While the SBI would provide such services in the Western region, the RBI has permitted the Canara Bank and PNB to concentrate on the Southern and Northern regions of the country, for providing such services for the customers. The major players since 1991 are Canbank Factors, SBI Factors and later Foremost Factors. The new entrants in the market include ICICI, HSBC and Global Trade Finance. Canback Factors leads in the domestic market with about .65%-70%of the share.

The Vaghul Committee Report on Money Market Reforms has stressed on the need for factoring services to be developed in India as part of the money market instruments. Many new instruments had already been introduced like Commercial Paper (CP), Pm1icipation Certificates (PC), Certificates of Deposits etc. but the factoring service has not developed to any significant extent in India.

Factoring in India - A Note

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The paper traces the genesis of factoring service in India, which is still in its infancy. It brings out the advantages and disadvantages of factoring. The potential for factoring has also been stated.

The eighties in India was witness to a virtual deregulation of capital market a number of innovative financial instruments and schemes was born. The policy of the power-that - be also helped in the development of money market. The capital market mutatis mutandis tried to transplant some of the successful schemes of the west. The working group (1987) on the money market, headed by Vaghul, observed: "Despite various measures taken over the years to enable the small-scale sector to recover its dues from the medium and large industries (and in particular the public sector) the small-scale units face a liquidity bind because of their inability to collect the dues". Since the earlier efforts to popularise a bill market in India did not have the desired results an alternative had to be found. Available data reveal that funds locked up in book debts have been increasing at a faster rate than growth in sales turnover or build-up in inventories (Anantha Krishnan, 1990).

Thus, factoring as a remedy became a fait accompli. A committee was constituted under the chairmanship of Kalyana Sundaram (198-) to examine the feasibility of factoring services in India and suggest operational modalities , s of launching such a service.

This note discusses the salient features of factoring and tries to analyse its relevance in the context of the changing financial scenario and the development of financial services industry.

Factoring is essentially a management (financial) service designed to help firms better manage their receivables; it is, in fact, a way of offloading a firm's receivables and credit management on to some one else - in this case, the factoring agency or the factor. Factoring involves an outright sale of the receivables of a firm by another firm specialising in the management of trade credit, called the factor. Under a typical factoring arrangement a factor collects the accounts on the due dates, effects payments to its client firm on these days (irrespective of whether or not it has received payment or not) and also assumes the credit risks associated with the collection of the accounts.

For rendering these services, the factor charges a fee which is usually expressed as a percentage of the total value of the receivables factored. Factoring is thus an alternative to in-house management of receivables. The complete package of factoring services includes (1) sales ledger administration; (2) finance; and (3) risks control.

Sales ledger administration: For a service fee, the factor provides its client firm professional expertise in accounting and maintenance of sales ledger and for collection of receivables.

Finance: The factor advances up to a reasonable percentage of outstanding receivables that have been purchased, say, about 80 percent immediately, and the balance minus commission on maturity. Thus, the factor acts as a source of short-term funds.

Risk Control: The factor having developed a high level of expertise in credit appraisal, reduces the risk of loss through bad debts.

Depending upon the inherent requirements of the clients, the terms of factoring contract vary, but broadly speaking, factoring service can be classified as (a) Non-recourse factoring; and (b) recourse factoring. In non recourse factoring, the factor assumes the risk of the debts going "bad". The factor cannot call upon its client-firm whose debts it has purchased to make good the loss in case of default in payment due to financial distress. However, the factor can insist on payment from its client if a part of the receivables turns bad for any reason other than financial insolvency.

In recourse factoring, the factoring firm can insist upon the firm whose receivables were purchased to make good any of the receivables that prove to be bad and unrealisable. However, the risks of bad debts is not transferred to the factor.

Legal Aspects

The legal status of a factor is that of an assignee. Once the factor purchases the receivables of a firm and this fact is notified to the customers, they are under a legal obligation to make all remittances to the factor' A customer who by mistake remits the payments to the firm is not discharged from his obligations to the factor until and unless the firm remits the proceeds to the factor. The factoring agreement governs the legal relationship between a factor and the firm whose receivables are to be factored, and is so drawn as to suit the various needs specifying the period of validity of the contract and modalities of termination.

Financial Aspects

Factoring involves two types of costs: (a) factoring commission; and (b) interest on funds advances.

Factoring commission represents the compensation to the factor for the administrative services provided and the credit risk borne. The commission charged is usually 2-4 per cent of the face value of the receivables factored, the rate depending upon the various forms of service and whether it is with or without recourse.

The factor also charges interest on advances drawn by the firm against uncollected and non-due receivables. In the Ul(, it is the practice to advance up to 80 per cent of the value of such outstanding at a rate of interest which is 2-4 per cent above the base rate. This works out to near the interest rate for bank overdrafts.

The cost of factoring varies, from 15.2 to 16.20 per cent (Singh, 1988), 15.6 to 16.0 percent (SBI Monthly Review, 1989), and the margins in which the factors will have to operate would be extremely narrow. The strategy of factors, therefore, must be to carve out a niche in the services segment namely, receivables management and generate revenues by way of commission rather than concentrate on lending and financing activities where the margins are low.

Factoring offers the following advantages from the firm's point of view:

Advantages

Firms resorting to factoring also have the added attraction of ready source of short-term funds. This form of finance improves the cash flow and is invaluable as it leads to a higher level of activity resulting in increased profitability.

By offloading the sales accounting and administration, the management has more time for planning, running and improving the business, and exploiting opportunities, The

reduction in overheads brought about by the factor's administration of the sales ledger and the improved cash flows because of the quicker payments by the customers result in interest savings and contribute towards cost savings.

Disadvantages

Factoring could prove to be costlier to in-house management of receivables, specially for large firms which have access to similar sources of funds as the factors themselves and which on account of their size have well organised credit and receivable management.

Factoring is perceived as an expensive form of financing and also as finance of the last resort. This tends to have a deleterious effect on the creditworthiness of the company in the market.

Potential

In the Indian context, factoring is being viewed as a source of short-term finance. The estimated aggregate potential demand for factoring (finance) would be about Rs 4,000 crores (SBI Monthly Review, 1989). There seems to be a tendency to view factoring primarily as a financing function - a source of funds to fill the void of bank financing of receivables for small-scale industries and others. This attitude is fraught with dangers and could lead to a "catch 22" situation.

In launching factoring service, the thrust should be in the twin areas of receivables management, and credit appraisal; factoring agencies should be viewed as vehicles of development of these skills. Since the small-scale sector lacks these sophisticated skills, factors should be able to fill the gap. Giving priority to financing function would be self-defeating as receivable management would be given the back-seat. It is for the factors to generate the necessary surpluses to mop up the additional resources and then embark on financing function. However, for policy reasons, should these go hand in hand, then the accent should be on receivable management otherwise, these agencies would end up as financing bodies.

From the firm's point of view, factoring arrangements offer certain financial benefits in the form of savings in collection costs, reduction in bad debt losses, and reduction in interest cost of investment in receivables. On the other hand, the firm incurs certain costs, in the form of commissions and interest on advances. Therefore, to assess the financial desirability of factoring as an alternative to in-house management of receivables, the firm must assess the net benefit of this option, using the profit criterion approach. The factors have to establish their credibility in offering better management of receivables and financing at competitive rates to the clients.

LESSON 14
BILLS DISCOUNTING

LESSON OBJECTIVES : TO UNDERSTAND THE CONCEPT OF BILLS DISCOUNTING AND
REGULATIONS RELATED TO BILLS DISCOUNTING.

INTRODUCTION

Bill discounting, as a fund-based activity, emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India. In the post-1992 (scam) period its importance has substantially declined primarily due to restrictions imposed by the Reserve Bank of India. The purpose of the Chapter is to describe bills discounting as an asset-based financial service. The aspects of bills discounting covered include its concept, advantages and disadvantages, bills market schemes, procedures and processing, post-securities scam position and some gray-areas. The main points are also summarised.

CONCEPT

According to the Indian Negotiable Instruments Act, 1881:
"The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument."
The bill of exchange (B/E) is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

Types of Bills

There are various types of bills. They can be classified on the basis of when they are due for payment, whether the documents of title of goods accompany such bills or not, the type of activity they finance, etc. Some of bills are:
Demand Bill This is payable immediately "at sight" or "on presentment" to the drawee. A bill on which no time of payment or "due date" is specified is also termed as a demand bill.
Usance Bill This is also called time bill. The term usance refers to the time period recognized by custom or usage for payment of bills.
Documentary Bills These are the B/Es that are accompanied by documents that confirm that a trade has taken place between the buyer and the seller of goods. These documents include the invoices and other documents of title such as railway receipts, lorry receipts and bills of lading issued by custom officials. Documentary bills can be

further classified as: (i) Documents against acceptance (D/A) bills and (ii) Documents against payment (DIP) bills.

D/ A Bills In this case, the documentary evidence accompanying the bill of exchange is deliverable against acceptance by the drawee. This means the documentary bill becomes a clean bill after delivery of the documents.

DIP Bills In case a bill is a "documents against payment" bill and has been accepted by the drawee, the documents of title will be held by the bank Dr the finance company till the maturity of the B/E.

Clean Bills These bills are not accompanied by any documents that show that a trade has taken place between the buyer and the seller. Because of this, the interest rate charged on such bills is higher than the rate charged on documentary bills.

Creation of a B/E Suppose a seller sells goods or merchandise to a buyer. In most cases, the seller would like to be paid immediately but the buyer would like to pay only after some time, that is, the buyer would wish to purchase on credit. To solve this problem, the seller draws a B/E of a given maturity on the buyer. The seller has now assumed the role of a creditor; and is called the drawer of the bill. The buyer, who is the debtor, is called the drawee. The seller then sends the bill to the buyer who acknowledges his responsibility for the payment of the amount on the terms mentioned on the bill by writing his acceptance on the bill. The acceptor could be the buyer himself or any third party willing to take on the credit risk of the buyer.

Discounting of a B/E The seller, who is the holder of an accepted B/E has two options:

1. Hold on to the B/E till maturity and then take the payment from the buyer.
2. Discount the B/E with a discounting agency. Option (2) is by far more attractive to the seller.

   The seller can take over the accepted B/E to a discounting agency bank,

NBFC, company, high net worth individual] and obtain ready cash. The act of handing over an endorsed B/E for ready money is called discounting the B/E. The margin between the ready money paid and the face value of the bill is called the discount and is calculated at a rate percentage per annum on the maturity value.

The maturity a B/E is defined as the date on which payment will fall due. Normal maturity periods are 30,60,90 or 120 days but bills maturing within 90 days seem to be the most popular.

Advantages : The advantages of bill discounting to investors and banks and finance companies are as follows:

To Investors

1. Short-term sources of finance;
2. Bills discounting being in the nature of a transaction is outside the purview of Section 370 of the Indian Companies Act 1956, that restricts the amount of loans that can be given by group companies;
3. Since it is not a lending, no tax at source is deducted while making the payment charges which is very convenient, not only from cash flow point of view, but also from the point of view of companies that do not envisage tax liabilities;
4. Rates of discount are better than those available on ICDs; and
5. Flexibility, not only in the quantum of investments but also in the duration of investments.

To Banks:

1. Safety of Funds The greatest security for a banker is that a B/E is a negotiable instrument bearing signatures of two parties considered good for the amount of bill; so he can enforce his claim easily.
2. Certainty of Payment A B/E is a self-liquidating asset with the banker knowing in advance the date of its maturity. Thus, bill finance obviates the need for maintaining large, unutilised, ideal cash balances as under the cash credit system. It also provides banks greater control over their drawls.
3. Profitability Since the discount on a bill is front-ended, the yield is much higher than in other loans and advances, where interest is paid quarterly or half yearly.
4. Evens out Inter-Bank Liquidity Problems The development of healthy parallel bill discounting market would have stabilized the violent fluctuations in the call money market as banks could buy and sell bills to even out their liquidity mismatches.

Discount Rate and Effective Rate of Interest Banks and finance companies discounting bills prefer to discount LlC (letter of credit)-backed bills compared to clean bills. The rate of discount applicable to clean bills is usually higher than the rate applicable to LlC-based bills. The bills are generally discounted up-front, that is, the discount is payable in advance. As a consequence, the effective rate of interest is higher than the quoted rate (discount). The discount rate varies from time to time depending upon the short-term interest rate. The computation of the effective rate of interest on bills discounting is shown in following illustration

Illustration

The Hypothetical Finance ltd. discounts the bills of its clients at the rate specified below:

(i) L/C - backed bills, 22 per cent per annum

(ii) Clean bill, 24 per cent per annum

Required: Compute the effective rate of interest implicit in the two types of bills assuming usance period of (a) 90 days for the L/C - based bill and (b) 60 days for the clean bill and value of the bill, Rs 10,000.

Solution *Effective Rate of Interest on L/C - based Bill:*

Value of the bill,	Rs 10,000	
Discount charge	Rs. 550	(Rs 10,000x 0.22 x 90/360)
Amount received by the client, = Rs 9,450		(Rs 10,000 - Rs 550)
Quarterly effective interest rate = 5.82%		[Rs 90 x 100/Rs. 9450]

Annualised effective rate of interest, [(1.0582)4- 1] x 100 = 25.39%

Effective Rate of Interest on Clean Bill:

Value of bill	Rs 10,000	
Discount Charge,	= Rs 400	(Rs 10,000 x 0.24 x 60/360)
Amount received by the client = Rs 9,600		(Rs 10,000 - Rs 400)
Quarterly rate of interest = 4.17%		(Rs. 400/Rs 9,600)x100

Effective rate of interest per annum, = 17.75%.

BILL MARKET SCHEMES

The development of bill discounting as a financial service depends upon the existence of a full-fledged bill market. The Reserve Bank of India (RBI) has

constantly endeavored to develop the commercial bills market. Several committees set-up to examine the system of bank financing and money market had strongly recommended a gradual shift to bills finance and phase-out of the cash credit system. The most notable of these were: (i) Dehejia Committee, 1969, (ii) Tandon Committee, 1974, (iii) Chore Committee, 1980 and (iv) Vaghul Committee, 1985. This section briefly outlines the efforts made by the RBI in the direction of the development of a full-fledged bill market.

BILL MARKET SCHEME, 1952

The salient features of the scheme were as follows:

(i) The scheme was announced under Section 17(4)(c) of RBI Act which enables it to make advances to scheduled banks against the security of issuance of promissory notes or bills drawn on and payable in India and arising out of bona fide commercial or trade transaction bearing two or more good signatures one of which should be that of scheduled bank and maturing within 90 days from the date of advances;

(ii) The scheduled banks were required to convert a portion of the demand promissory notes obtained by them from their constituents in respect of loans/overdrafts and cash credits granted to them into usance promissory notes maturing within 90 days to be able to avail of refinance under the scheme;

(iii) The existing loan, cash credit or overdraft accounts were, therefore, required to be split up into two parts, that is:
   (a) one part was to remain covered by the demand promissory notes, in this account further withdrawals or repayments were as usual being permitted;
   (b) the other part, which would represent the minimum requirement of the borrower during the next three months would be converted into usance promissory notes maturing within ninety days.

(iv) This procedure did not bring any change in offering same facilities as before by banks to their constituents. Banks could lodge the usance promissory notes with RBI- for advances as eligible security for borrowing so as to replenish their loanable funds.

(v) The amount advanced by the RBI was not to exceed the amount lent by the scheduled banks to the respective borrowers.

(vi) The scheduled bank applying for accommodation had to certify that the paper presented by it as collateral arose out of bona fide commercial transactions and that the party was creditworthy.

(vii) The RBI could also make such appropriate enquiries as it deemed fit, in connection with eligibility of bills and call for any further information from the scheduled banks concerned.

(viii) Advances to banks under the scheme, in the initial stages, were made at one-half of one per cent below the bank rate. The confessional rate of interest was withdrawn in two stages of one quarter of one per cent each and ceased to be operative from November 1956.

(ix) As a further inducement to banks, the RBI agreed to bear half the cost of the stamp duty incurred in converting demand bills into time bills.

(x) In the initial stages the minimum limit for an advance which could be availed of from the RBI at any time was fixed at Rs 25 lakh and the individual bills tendered for the purpose were not to be less than rupee one lakh. Subsequently, however, the scheme was liberalised and the minimum amounts were reduced from Rs 25 lakh to Rs 10 lakh (reduced further to Rs 5 lakh in February 1967) and from Rs I lakh to Rs 50,000. The scheme, which was initially, restricted to licensed scheduled commercial banks having deposits (including deposits outside India) of Rs 10 crore or more was later extended to all licensed scheduled commercial banks, irrespective of the size of their deposits.

The scheme virtually ceased to function in 1970. The main reasons being:

(i) Lack of specialised institutions for discharging the functions of acceptance and discount houses;
(ii) Paucity of usance bills-both domestic and foreign;
(iii) Traders found cash credit facility conveniently available from banks and avoided usance bills as an instrument of credit;
(iv) Export bills were negotiated by banks under letters of credit opened by foreign importers and foreign correspondent banks;
(v) Banks got refinance against declaration of export bills from RBI Exim-Bank when needed;
(vi) Lack of practice of discounting the bills with other banks having excess liquidity;
(vii) Criteria for creditworthiness of the traders was not evolved to avoid risk of defaults of redemption on maturity of the bills.

Bill Market Scheme, 1970

In pursuance of the recommendations of the Dehejia Committee, the RBI constituted a working group (Narsimham Study Group) to evolve a scheme to enlarge the use of bills. Based on the scheme suggested by the study group, the RBI introduced with effect from November 1, 1970, the new bill market scheme in order to facilitate the re-discounting of eligible bills of exchange by banks with it. To popularise the use of bills, the scope of the scheme was enlarged, the number of participants was increased, and the procedure was simplified over the years. The salient features of the scheme are as follows:

Eligible Institutions All licensed scheduled banks and those which do not require a licence (i.e. the State Bank of India, its associate banks and natioanlised banks) are eligible to offer bills of exchange to the RBI for rediscount. There is no objection to a bill accepted by such banks being purchased by other banks and financial institutions but the RBI rediscounts only such of those bills as are offered to it by an eligible bank.

Eligibility of Bills The eligibility of bills offered under the scheme to the RBI is determined by the statutory provisions embodied in section 17(2)(a) of the Reserve Bank of India Act, which authorise the purchase, sale and rediscount of bills of exchange and promissory notes, drawn on and payable in India and arising out of bona fide commercial or trade transactions, bearing two or more good signatures, one of which should be that of a scheduled bank or a state co-operative bank and maturing:

(a) In the case of bills of exchange and promissory notes arising out of any such transaction relating to the export of goods from India, within one hundred and eighty days;

(b) In any other case, within ninety days from the date of purchase or rediscount exclusive of days of grace;

(c) The scheme is confined to genuine trade bills arising out of genuine sale of goods. The bill should normally have a maturity of not more than 90 days. A bill having a maturity of 90 to 120 days is also eligible for rediscount, provided at the time of offering to the RBI for rediscount it has a usance not exceeding 90 days. The bills presented for rediscount should bear at least two good signatures. The signature of a licensed scheduled bank is treated as a good signature;

(d) Bill of exchange arising out of the sale of commodities covered by the selective credit control directives of the RBI have been excluded from the scope of the scheme to facilitate the selective credit controls and to keep a watch on the level of outstanding credit against the affected commodities; and

(e) The following types of bills are acceptable to RBI for the purpose of re-discount:

  (i) Bills drawn on and accepted by the buyer's bank,

  (ii) Bills drawn on buyer and his banker jointly and accepted by them jointly,

  (iii) Bills drawn on and accepted by the buyer under an irrevocable letter of credit and certified by the buyer's bank which has opened the letter of credit in the manner specified by RBI, that is, that the terms and conditions of the letter of credit have been duly complied with by the seller.

  (iv) Bills drawn on and accepted by the buyer and endorsed by the seller in favour of his bank and bearing a legend signed by a licensed scheduled bank which should endorse the bill, confirming that the bill will be paid by bank three days before the date of maturity,

  (v) Bills drawn and accepted in the prescribed manner and discounted by a bank at the instance of the drawee.

Where the buyer's bank is not a licensed scheduled bank, the bill should additionally bear signature of a licensed scheduled bank.

Procedure for Rediscounting Eligible banks are required to apply to the RBI in the prescribed form giving their estimated requirements for the 12 month ending October of each year and limits are sanctioned /renewed for a period of one year running from November 1 to October 31 of the following year. The RBI presents for payment bills of exchange rediscounted by it and such bills have to be taken delivery) by the rediscounting banks against payment, not less than three working days before the dates of maturity)f the bills concerned. In case bills are retired before the dates, pro-rata refund of discount is allowed by the RBI.

For rediscounting purposes, bills already rediscounted with RBI may be lodged with it. The un-expired period of the usance of the bills so offered should not be less than 30 days and the bills should not bear the endorsement of the discounting bank in favour of a party other than the RBI.

Banks to Hold Bills Rediscounted In the first year of the operation of the scheme, the banks are required to lodge all eligible bills with the RBI for availing themselves of

the rediscounting facilities. 11 November 1971, actual lodgement of bills of the face value of Rs 2 lakh and below was dispensed with od the banks were authorised to hold such bills with themselves. This limit was increased to Rs 10 lakh in November 1973. The banks are required to make declarations to the effect that they hold eligible bills of a particular aggregate value on behalf of the RBI as its agents, and on this basis the RBI pays to them the is counted value of such bills. The discounting banks are also required to endorse such bills in favour of the BI before including them in the declarations and also re-endorse the bills in their own favour when they "e retired. Since 1975, banks are permitted to rediscount bills with other commercial banks as well as ~rtain other approved financial institutions. Since June, 1977, there is a ceiling on the rate of rediscount on Ich bills which has been varied by the banks from time to time.

The bill rediscounting scheme over the years has been gradually restricted and at present this facility is treated by the RBI on a discretionary basis. During the year 1981-82 (July-June) no fresh bill rediscounting limits were sanctioned to the banks and as such there were no outstanding under the scheme from October 23, 1981. The amount of bills rediscounted each year has shown wide variations, but during each . the four years (1974-75 to 1977-78) (April-March), the volume had been well over Rs 1,000 crore; in sequent years a comparative declining trend set in the utilisation of the facility due to its being available only on discretionary terms.

In order to revitalise the bill market scheme, several committees made recommendations in the light of experience of the operations of the scheme. On the basis of these, several measures were initiated by the n to promote bill financing. The important ones being: (1) a ceiling on the proportion of receivable (75 per cent) eligible for financing under the cash credit system, (2) discretion to banks to sanction additional hoc limits for a period not exceeding 3 months, upto an amount equivalent to 10 per cent of the existing I limit subject to a ceiling of Rs 1 crore, (3) stipulation on ratio of bill acceptance to credit purchases (25 per cent), (4) setting up of the Discount and Finance House of India (DFHI) to buy/sell/discount short-term Is, (5) reduction in the discount rate on usance bills, (6) remission of stamp duty on bills drawn on/made 'in favour of a bank/cooperative bank. The procedure requiring the bill to the endorsed and delivered to re discounter at every time of rediscounting has been done away with. A derivative usance promissory note is issued by the discounter on the strength of the underlying bills which have tenor corresponding to, or lesser than, tenor of the derivatives usance promissory note and in any case not more than 90 days. The derivative promissory note is exempted from stamp duty.

The re-discounting facility from the RBI has gradually slowed and banks have been encouraged to rediscount bills, with one another as well as with approved financial institutions such as LIC, GIC, UTI, ICICI, IRBI, ECGC, selected cooperative banks and mutual funds and so on. Processing/Precaution/Defaults/Grey Areas Credit Assessment Banks and NBCFs (the main discounting agencies) undertake a detailed appraisal of a customer and thoroughly assess his creditworthiness before providing the bills discounting (BD) facility. Regular credit limits are fixed by banks and NBFCs for individual parties for purchase and discounting of clean bills and documentary bills separately. These limits are renewed annually and are based on the following considerations:

(i) Quantum of business undertaken by the party, that is, turnover of inventory;

(ii) Credit worthiness of drawer (client);
(iii) Credit worthiness of drawee and details of dishonor, if any;
(iv) Nature of customer's industry.

Appraisal of the customer is done through several means:

1. The most important step is a careful scrutiny of the customer's operations and its financial viability. For this, a detailed analysis of his financial statements is carried out.
2. Since the liability of the drawee also arises in case he accepts and dishonors the bill, credit information about the drawee is also collected. The drawer is asked to furnish a list of his purchasers and their banks so that a report of their credit risk can be compiled. This is especially easy for banks, as a confidential report can be easily routed through banking channels.
3. Banks have access to frequently published Indian Banks Association (IBA) bulletins which indicate the names of unsatisfactory drawees banks and their default rates.
4. Both banks and NBFCs have built up substantial credit intelligence database which are constantly updated based on market information. Once a client defaults, he is blacklisted and may find it difficult. to discount his B/E subsequently.

Thus, in case of an existing client it is assessed that there is no overdue bill pending and the clients' limits cover the amount of the bill submitted for discounting. In the case of a new client thorough enquiry about the creditworthiness of the party is made from the banker of the client, market and other finance companies. Once satisfactory report is obtained, a limit is normally fixed for the party. An effort is made to ensure that the risk is well spread amongst several drawees. In order to keep a proper control, there should be proper follow up of the bills due and the limits fixed for the clients should be reviewed/reassessed at an appropriate interval of time. Special attention is paid to the following points while reviewing bills discounting limits: .

(i) The earlier sanctioned limits are fully utilised by the client;
(ii) The bills were promptly paid on maturity date;
(iii) In case of unpaid bills, funds were paid by the drawer.

Once the party is granted a bill discounting limit, the party approaches the finance company for each and every bill for discounting. The following documents are submitted along with the letter of request:

(a) Invoice; (b) Challan; (C) Receipt of goods acknowledged by buyer;
(d) Hundi/Promissory note; (e) Truck receipt/Railway receipt;
(f) Post dated cheque for the interest amount.

While fixing the limit for bill discounting the balance sheet and profit and loss account are properly analysed and various ratios are calculated to arrive at a sound business decision.

Precautions The finance companies take following precautions while discounting bills:

(i) The bills are not accommodation bills but are genuine trade bills.
(ii) Bills are drawn on the places where the finance company is operating or has a branch office as it would facilitate contact with drawee in case of exigencies.

(iii) The goods covered by the documents are those in which they party deals.
(iv) The amount of the bills commensurate with the volume of business turnover of the party.
(v) Bills are drawn on a place where the goods have been consigned.
(vi) The credit report on the drawee is satisfactory.
(vii) The description of goods mentioned in the invoice and railway receipt/truck receipt are same.
(viii) The goods are not consigned directly to the buyer.
(ix) The goods are properly insured.
(x) The usance bill is properly stamped.
(xi) Bills offered for discount do not cover goods whose prices fluctuate too much.
(xii) The goods covered under the bill are not of perishable nature.
(xiii) The bills are not stale.
(xiv) The truck receipt is in the form of prescribed by the Indian Banks Association.
(xv) The bills are drawn in favour of the finance company and have been accepted by the drawee.

Dealing with Default The cycle of liabilities in a bill discounting transaction is as follows: The drawee is liable to the drawer; and the drawer to the discounting agency. However, the bank/INBFC looks mainly to its customer (drawer or drawee) for recovery of its dues. In case of default, the discounting agency can resort to noting and protesting as laid down by the Negotiable Instrument Act. In reality, however, since litigation is both cumbersome and expensive, a combination of negotiation and compromise is used. At worst, some dues ,may be written off. NBFCs generally build-in a large number of safeguards to guard against default. Banks generally discount LC- backed bills which are default-proof.

Grey Areas There are certain features of the Indian industry which have impeded the growth of a healthy bill discounting market (BD):

Participants Most of the customers approaching banks/NBFCs for bills discounting are SSI (Small scale industries) units. For such enterprises, it is very difficult to undertake proper credit assessment.

Kite Flying The practice of discounting accommodation bills is known as kite flying. When A draws a BI E on B without there being any underlying movement of goods and B accepts it to accommodate A, the BI E is called an accommodation kite bill. If A now 'discounts it, he has uninterrupted use of funds for the maturity period of the bill. These funds are generally routed into the capital market to earn a very high return on the due date the amount of the B/E is repaid by A. This practice has severally stilted the genuine bill market, by imparting false liquidity to the system.

Supply Bills B/E drawn by suppliers/contractors on Government departments are called supply bills, These are not accepted by the Government. However, contractors are able to get them discounted with nationalised banks. If there is a default on the due dates, banks simply debit the dues to the 'Government a/c'. This practice depresses the level of cash flow in the bill market because a B/E is being discounted without a corresponding flow of cash.

Reduced Supply Several corporate houses and business groups do not accept B/E drawn on them. Accepting such bills is seen to be damaging to their pride. Such

attitudes reduce the supply of bills and discourage the culture of drawing and discounting bills.
Stamp Duties No stamp ~duties are levied on LC (letter of credit) backed bills upto 90 days. This has resulted in a lop sided growth in the bills market with practically no bills being drawn for a period exceeding 90 days. The market, therefore, lacks depth.

PRESENT POSITION OF BILLS

DISCOUNTING

Financial services companies had been acting till the early nineties as bill-brokers for sellers and buyers of bills arising out of business transactions. They were acting as link between banks and business firms. At times they used to take up bills on their own account, using own funds or taking short-term accommodation from banks working as acceptance/discount houses. They had been handling business approximating Rs 5,000 crores annually. Bill discounting, as a fund-based service, made available funds at rates I per cent lower than on ash credit finance and bill finance constituted about one-fourth of bank finance.

However, the bill re-discounting facility was misused by banks as well as the bill-brokers. The Jankiraman Committee appointed by the RBi which examined the factors responsible for the securities-scam identified the following misuse of the scheme:

Banks have been providing bill finance outside the consortium without informing the consortium bankers;

- They have been drawing bills on companies and they themselves discounted such bills to avail of rediscount facilities;
- In cases where banks provided additional finance outside the consortium arrangement by way of bill limits covering sales of goods, the sales proceeds had been unavailable to them to provide production finance;
- Bill finance had been provided to dealers/ stockiest of large manufacturing companies without proper appraisal of their credit needs;
- Bills discounted by front companies set up by industrial groups on their parent companies which were obviously accommodation bills were discounted/ rediscounted by banks;
- The rediscounting of bills by finance companies with banks was done at a much lower rate of interest;
- Although bills are essentially trade documents, bills related to electricity charges, custom charges, lease rentals etc. were also discounted. This was mainly due to the lack of depth in the bills market and NBFCs felt the need for new instrument or schemes to increase their business.
- No records regarding bill discounting were ever maintained by banks.

In order to stop misuse of the bill discounting facility by banks, the RBI issued guidelines to banks in July 1992. The main elements of these guidelines are as follows:

(i) No fund/non-fund based facility should be provided by banks outside the consortium arrangement;
(ii) Bill finance should be a part of the working capital credit limit;
(iii) Only bills covering purchase of raw materials/inventory for production purposes and sale of goods should be discounted by banks;
(iv) Accommodation bill should never be discounted;
(v) Bill re-discounting should be restricted to usance bills held by other banks. The banks should not rediscount bills earlier discounted by finance companies;
(vi) Funds accepted by banks for portfolio management should not be deployed for discounting bills.
(vii) Overall credit limit to finance companies including bills discounting should not exceed three times the net worth of such companies; and
I
(viii) For discounting LC-backed bills by NBFCs, the bill must be accompanied by a no-objection certificate from the beneficiary bank.

As a result, there was substantial decline in the volume of bill discounting. Presently, the volumes are on average Rs 80-100 crore per month and Rs 800 - 900 crore per year. The ban on re-discounting has also resulted in falling margins for the NBFCs.

**FINANCING WORKING CAPITAL:
EMERGING OPTIONS**

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In this paper an attempt has been made to cover conceptual, decisional, and policy issues concerning financing of working capitaL Most of the issues in this area are controversial Both in thought and in action, the area of management and financing of working capital has, in modem history, always been characterised by bifoculism, paradox, and ambiguity. This has happened mainly because of the conceptual ambiguities which have always been taken advantage of by the practitioners. This paper attempts to clarify some of the basic concepts. It brings out the emerging options in this growing field. It concludes that in the days to come the varieties of instruments will proliferate, but cautions that they will become popular only with the introduction of CDs and CPs.

The conceptual bi-foculism can be traced back to Adam Smith's Wealth of Nations published towards the end of the 18th century. This was also evident in the classic controversy between the banking and the currency schools in the 19th century (Singh, 1975). It is also current in the present day world as the difference in views of the economist and the businessman.

In other words, there have always been two focuses on working capital and its financing. The economist has been concerned largely with real investment and real output. and, with the real assets and their financing. This focus has, therefore, mainly been on the balance sheet, the stock variables, the credit allocation and the credit multiplier. Further, in this line of thinking, the emphasis has been on investment (in inventory and book debts), the operating cycle, and the optimisation of the turnover of the working capital or what has sometimes been called the circulating capital. It is generally assumed that the coefficients relating the stock variables of inventory and book debts to output and sales are technologically determined and fixed in the short run. However, in real life, these coefficients have tended to vary with innovations in managerial practices and, in some cases, have tended to assume even zero values. The economist has, in general, also considered finance as superfluous or mere numeraire.

The other focus has always been held by the businessmen. They consider finance having its own significance. Atypical illustration is that of a partner withdrawing his capital and therefore affecting the liabilities side of the balance sheet, and not the assets side. The dominant focus of the business world has been the cash flow: the flow variables, the cash gap, or the surplus or the deficit arising out of differences

between the total cash inflows and the total cash outflows during a given period of time.

In this line of thinking, the funds or the money or the purchasing power (defined as cash plus credit) has to be viewed as flows into and out of a common pool. It implies that it is not very relevant to link the specific sources of financing to either the circulating or fixed assets. The cash gap is determined by the totality of financial flows arising as a result of either acquisition or sale of any type of asset, and, also as a result of contracting of new liabilities or paying off of the old ones. The typical businessman does not feel comfortable with any linkage of specific type of liability to any specific type of asset. For him, money is money, and it has to be managed on the basis of overall cash surpluses or cash deficits arising out of the operations during a particular period of time. Of course, the financial world has always made a distinction between the capital employed or the resource finance on the one hand, and the short-term credit or the recourse finance, on the other. They have always linked the short period cash gaps with financial credit.

The two views are no doubt different. The economist would like to correlate the usage of financial credit with the output and seek to maximise the credit multiplier. This is the basic reasoning relating investment and output, on the one hand, and with money and prices, on the other, with which the central monetary authorities all over the world are always concerned. Viewed in this perspective, no doubt, it makes sense. But, the business world has always looked beyond such relationships and asserted that financial credit should be related to cash gaps arising not only as a result of investment but also because of changes in the liabilities. Thus far, this reasoning appears to be justified. The trouble arises when the businessman's view is extended and assumes the character of money games, what Iacocca (1985) calls as going beyond manufacturing and marketing to earn money on money. Such games always carry with them the element of controversy. They can, and generally have degenerated into market crashes. Moreover, the history has always faced the ethical question of earning rewards without any sacrifice or taking of risk. In today's world when attempts are being made to popularise the Islamic banking, the ethical issue of Riba cannot be totally set aside.

The other important conceptual issue is the distinction between the two definitions of working capital. Assuming the economist's identification of the problem as that of financing investment in working capital assets, one definition of working capital is the investment in circulating assets, or in inventory and book debts comprising the operating cycle of a manufacturing-cum-marketing firm. With trade creditors or the account payable deducted, it is also known as the net operating cycle. It may also be noted that investment in assets comprising the gross operating cycles are conventionally called the current assets. These, in turn, are defined as assets which in normal course of operations are meant to be converted into cash within a period not exceeding one year. Correspondingly, for the concept of current liabilities the definition restricts them only to those liabilities which, in normal course of operations, are meant to be paid within a period of next 12 months. It is apparent that circulating working capital or current assets, and, current liabilities are basically in the nature of renewable aggregates. Their levels fluctuate within a year. There may

be higher or lower degrees of seasonalities in their levels for different firms. But there is always a core element which may keep continuously rising over the long run.
The other concept is that of the net working capital. It is defined as the difference between the current assets and the current liabilities. Implicit in this definition is the principle that the entire amount of current assets should not be financed out of current liabilities which includes short-term financial credit. In other words, the ratio between the current assets and the current liabilities should always be greater than one. One reason which supports the principle is that the excess of current assets over current liabilities, the net working capital, represents the safety margin available to the creditors of the firm, and therefore, represents the liquidity strength of the company.

It determines in a large measure its creditworthiness in the market. The other reason is that the core part of investment in working capital assets which has the character of long-term investment should be financed not out of financial credit or recourse finance but out of the resource finance or the capital funds. Most of the current controversies in the area of financing working capital in India today are based on the conceptual differences presented above. In the latter part of the paper, an attempt will be made to highlight these in the context of the emerging scenario in India.

It may also be added, as part of introduction, that the statistical data used in the paper are contained in the three tables in the text. All the figures have been taken from various publications of the Reserve Bank of India. Data on variables relating to the corporate world are taken from the Reserve Bank studies on financing of large and medium sized companies in India based on a sample of 1,650 companies. The Reserve Bank has been changing the size of the sample. The statistics contained in the tables used in this paper has been worked out on the basis of the uniform size of the sample for all the years, from 1969 to 1989.

Historical Context

In general, it can be stated that bank credit has all over the world been a major source of financing the working capital. However, in their details, policies and practices in India have been very different from those obtaining in the developed countries. In the west, the major focus has been on short-term financing or the seasonal bank credit to meet the requirements of the fluctuating component of the cash gaps. In other words, the banks in the developed countries provide financial credit for filling short-term cash gaps as part of the working capital finance and not the fixed component or the long-term cash gaps.

Moreover, the amount of bank credit made available to industry is determined by cash gaps and not by the amount of investment in inventory and book debts. This has two implications. First, the availability of financial credit from banks is determined by the need for cash liquidity and the lending is not related to the availability of security of current assets. The banks try to carefully assess that the borrowing company will be able to repay the short-term loans/credit within a period of 365 days, that is, bring liability to bank to zero for some time during the year. The banks provide credit on the strength of the creditworthiness of the borrowing company which, in turn, is also determined by the strength of the current ratio and the amount of net working capital.

In other words, a sizable part, the fixed component of investment in working capital, is financed out of long-term capital funds.

In India, the present policies and practices have evolved in a particular historical context. It may be stated that in this country creditworthiness as judged by the strength of the current ratio and the net working capital has never been the overriding criterion for the commercial banks to decide to lend funds for financing the working capital. The major consideration has been the current assets charged in favour of the bank as security against borrowing. Therefore, the correlation between the bank credit available to industry and the holding of inventory and book debts by it should be positive and very high. In reality, this is not so because the security basis is, in fact, not followed strictly. Compliance is largely only on paper.
Further, it also implies that bank credit in large part is not meant to assume the character of the filler of short-term cash gaps. Under the Indian conditions, banks, in general, finance the fixed component or investment in core current assets as well. No distinction is made in practice between the fixed and fluctuating components of the working capital finance by the commercial banks. The result is that in a vast majority of cases, and most of the time, the current ratios are low, and the net working capital is thin.

There are reasons to justify this major deviation from the international practice. India has in recent years built up a big industrial set-up and is generally rated, judged by the size of investment in its industry, as the eighth or the ninth -industrial nation in the world. This industrial growth has been made possible because of the national policies aiming at targeted investment for deliberate import substituting industrialisation. Easier access to bank credit has, no doubt, contributed towards faster growth of investment in industry.

In short, in an economy engineered by national planning, the economist's view has dominated the policy formulation. This means that the focus has largely been on relating bank credit to investment in working capital. This approach has also derived its strength from the long-standing practice of the banks of lending against the security of the assets.
While in the two decades of the 50s and the 60s, the emphasis was on asking the banks to lend, or, as it has euphemistically been called to provide larger short-term bank credit to industry, the underlying idea was to get away from "security based" lending to "need based" lending. During those years, it was felt that the banks were restricting the availability of credit to industry by following strict norms relating to margins and by lending against the security of current assets. The industry wanted security margins to be lowered and more credit made available to them by the banks so as to meet the need for more investment in inventory and book debts so as to keep their operations growing.

Liberalisation of policies and practices during those years led to criticism in the banking circles. It was said that the banks were getting farther and farther away from financing the fluctuating or the short-term requirements of the industry and were getting involved deeper and deeper into financing of what was described as permanent core financing by the Dehejia Committee report in the late 60s. It was also

asserted that the relationship between the availability of bank credit and growth of industrial output was getting weaker, because bank credit was being utilised for acquiring long-term fixed assets and for holding speculative and flabby inventories.
It is in this background that the Tandon Committee (1975) reviewed the bank credit policies and practices in the early 70s. It recommended that adequate information on prescribed format should be made available by the borrowing companies to the commercial banks to enable the latter to practice need based lending. Secondly, it also recommended norms for investment in inventories and book debts, so that the borrowing companies should not cross the outer limits of reasonable requirements of working capital finance. Thirdly, it also laid down that a certain minimum amount of investment in working capital should be financed by long-term capital funds which really meant laying down a minimum current ratio. Its recommendations were implemented; they formed the basis of policies and practices in 70s and the 80s.

Two points are important in this connection. First, the Tandon committee emphasised need based credit, but it could not adequately provide for the criterion of creditworthiness. It ignored the fact that Indian commercial banks were moving into a position in which they were taking more than normal risking lending. A distinction between fixed and fluctuating components of bank credit was made. But on the requests of the banker and the borrowers, the policy makers decided later to drop this feature after a brief experimentation. Second, it cannot also be claimed that the guidelines issued by the Reserve Bank to the commercial banks based on the Tandon Committee recommendations were in practice implemented with adequate care during the two decades. However, on paper, the guidelines still remain the basis to be followed by the commercial banks for providing working capital finance to the industry.

Despite many attempts for improvement (including Tandon Committee formulations), policies and practices in the area of financing working capital by commercial banks in India are full of bifoculism, paradoxes, and ambiguities. The fact is that three different sets of criteria which in many respects do not agree with each other are being followed simultaneously in practice. The first is the basis laid down by the Tandon Committee which is used in - credit appraisals for determining the credit needs of the borrowing companies so as to enable the commercial banks to fix and sanction credit limits which cannot be exceeded during the period for which they are sanctioned.

These are based on the calculation of the maximum permissible bank finance worked out as per the norms and the method laid down originally by the Tandon Committee and revised marginally by the Reserve Bank of India in subsequent years.
For an illustration, let it be assumed that the maximum permissible bank finance, and based on that the total limit sanctioned works out to Rs 100 crores in the case of Company X. The practice also demands simultaneous observance of the old security criterion. In other words, the company would not be permitted on any day during the period for which the limit has been sanctioned, to draw an amount exceeding its drawing power, which is arrived at by deducting the stipulated margins from the book value of the inventories and book debts hypothecated to the banks as securities. This drawing power, in practice, is most likely to be either more or less than Rs. 100 crores for the company X, that is, the total limit sanctioned. Therefore, interesting situations

arise where companies have higher limits sanctioned but lower drawing power and vice versa. Then there is the third paradox. As part of reality, there will be actual drawings from the bank(s) by the companies which will fluctuate on day-to-day basis. These drawings are made, in accounting terminology, largely from the cash credit accounts. It is interesting to note that this account which is the centrepiece of the Indian system is operated on the basis of cash flow mechanism. Any cheque, irrespective of the fact, whether it is related to payments in respect of current assets or fixed assets or repayment of current or non-current liabilities, can be debited to this account. The same applied to credits. In other words, the essence of the matter is that operationally the borrower finances the overall cash gap based on cash flows. Since, in practice, for the company X all three figures of the total limit sanctioned, the drawing power and the drawings are at any time not likely to equal I 00, it gives rise to dissatisfaction, criticism, and lack of faith in the wisdom of the policies and practices.

Empirical Context

A look at the statistical facts relating to the last two decades leads to interesting results. Important conclusions are as follows:

I It can be said that availability of bank credit which has been the main source of financing working capital of the Indian industries has not been a problem. More credit flowed to industry with the passage of time. In other words, demand and supply matched very well. On an average, during the two decades of the 70s and 80s, bank credit availed by industry in India grew at a linear rate of 14.4 per cent per year. This takes care of the average annual rate of growth of industrial output of 5.6 per cent per year plus the inflation rate of 8.6 per cent. This was made possible largely because of easy market conditions or the high liquidity position of the banks. During these years, the savings rate was high and the bank deposits grew, on an average, by about 20 per cent per year.

Although more credit was allocated to the priority sectors, the industry could be accommodated fully to meet its growing, demand of bank credit to finance its working capital. Access to credit has not been a problem, but interest burden on the industry has been growing fast and the cost of credit has been a major area of concern. This has largely been caused by high rates of interest, high borrowings, and high investment in inventories and book debts; which, in turn, happened because the industry tended to record a low turnover of their current assets and because lower percentage of capital funds was used for financing the working capital.

2 Tables 1 -3 show that on an average, the ratio between chargeable current assets and the sales, or, the turnover for RBI sample companies during the 70s and the 80s was 2.42. As per its norms, the Tandon Committee laid down a minimum turnover ratio of 2. The Indian industry has at macro-level been close to the minimum. Along with low turnover ratio of working capital assets the current ratio indicating availability of capital funds to finance working capital has been too low. On an average, it was around 1.21 which is lower than the minimum ratio of 1.33 laid down by the Tandon Committee. Or, to put it differently, on an average, only 16.9 per cent of the total current assets were financed by long-term capital funds (or the net working capital), whereas the minimum required by the RBI guidelines based on the Tandon Committee guidelines was 25 per cent to reach the 1.33 current ratio. These two

indicators lead to the conclusion that high interest rate has been caused largely because of the low levels of the two critical ratios.

3 In table 3, the compound annual rates of growth have been worked out in percentage for the RBI sample of 1,650 large- and medium sized companies over the years 1971-72 and 1986-87. These growth rates show that the interest expenses grew at the rate of 16.1 per cent per year, whereas the sales grew only by 12.1 per cent per year. It is also interesting to observe that the inventory grew over the period only qt an annual compound rate of 7.5 per cent. But, at the same time, the book debts increased by 17.4 per cent which is much higher than the rate of growth of sales thereby affecting the over-all investment in inventory plus book debts. This did not permit improvement in over-all ratio of turnover of current assets. At the same time, because of the current ratio and net working capital position did not improve the short-term borrowing from banks increased for the sample companies at an annual rate of 16.5 per cent It may also be noted that the increase in net investment in fixed assets increased by 15 per cent per year, that is, faster than the sales, necessitating a much higher rate of growth of 26.4 per cent per year in long-term borrowings. All these factors put together explain the high rate of increase in interest expenses. Therefore, as it has already been pointed out earlier, the high interest costs have been a cause of serious concern of the Indian industry, particularly now when the environment is becoming more competitive.

Year Wholesale price index [% rate of growth] Industrial production [% rate of growth] Total Industry Small Industry Large & Medium Industry

1970-71	5.5	5.1	29.7	38.5	36.4
1971-72	5.6	4.4	24.1	15.6	25.9
1972-73	10.0	5.9	10.2	19.2	8.3
1973-74	20.2	0.5	22.6	32.8	20.4
1974-75	25.2	1.9	22.0	18.5	22.9
1975-76	1.0	5.3	16.4	12.8	17.3
1976-77	2.0	12.2	2.6	23.9	2.2
1977-78	5.2	3.4	10.8	19.9	8.3
1978-79	0.0	6.9	7.6	26.5	1.6
1979-80	17.1	1.2	17.8	22.1	16.1
1980-81	18.2	0.7	14.2	19.1	12.2
1981-82	9.3	9.2	19.4	26.1	16.4
1982-83	2.6	3.1	33.9	12.9	44.1
1983-84	9.4	6.7	1.5	20.7	5.5
1984-85	7.0	8.5	10.3	21.3	4.9
1985-86	5.7	8.7	12.6	19.8	8.7
1986-87	5.3	9.1	16.0	16.6	15.7
1987-88	7.6	7.5	30.0	4.3	48.8
1988-89	-	-	19.4	17.2	20.4
1989-90	-	-	27.3	22.5	29.4
Average rate of growth	8.61	5.6	14.4	20.4	13.8

Recent Past

Taking an overall view, the two decades of the 70s and the 80s were characterised by the domination of the economists' view over the view of the business community. There are several important implications on this development.

First, it is difficult to judge the success of the new need based basis of lending followed by commercial banks for working capital investment based on the system recommended by the Tandon Committee. Statistically, there was some improvement in inventory turnover ratios, but there was no impact on book debts resulting ultimately in higher short-term borrowings and higher interest expenses. The net working capital position also did not improve. But, in qualitative terms, the improvement in terms of greater awareness and systemic changes within industry as well as within the commercial banks was significant. Many companies in the country started taking management of their working capital and its financing more seriously than before.

Table: Financing of Current Assets

Year	Sales /	CCA NWC /	TCA x 100 CR = CA /CL
1971-72	2.19	17.9	1.21
1972-73	2.32	17.3	1.21
1973-74	2.24	16.4	1.20
1974-75	2.25	20.4	1.26
1975-76	2.31	17.8	1.22
1976-77	2.50	18.4	1.23
1977-78	2.54	6.6	1.10
1978-79	2.52	16.8	1.20
1979-80	2.48	17.9	1.22
1980-81	2.51	17.9	1.22
1981-82	2.49	17.9	1.22
1982-83	2.40	17.1	1.21
1983-84	2.45	17.1	1.21
1984-85	2.57	15.6	1.19
1985-86	2.49	17.5	1.21
1986-87	2.42	17.6	1.21
Average ratios	2.42	16.9	

Table: Compound Annual Rates of Growth

Particulars	1971-72	1986-87	Compound rate of growth in %
1. Sales	7851	43861	12.1
2. Changes in the balance sheet Amounts of inventory	302	897	7.5
3. Net investment of funds in fixed assets during the period	404	3301	15.0
4. Change in the level of trade credit changed	82	915	17.4
5. Change in the level of trade credit	106	626	12.5

obtained			
6. Change in the level of short term borrowings	85	843	16.5
7. Change in the level of long term borrowings	48	1631	26.4
8. Interest expenses	257	2403	16.1

Second, the business community reacted sharply to some of the rigidities and conditionalities built into the new system of bank lending for working capital. It can be argued that there was a genuine need for laying down of a few norms by the central monetary authority in the country, in the early 70s. They have served a useful historical purpose in focusing on the criticalities of management of industrial finance. That phase is now over. It will be a mistake to carry forward the norm-based micro-level approach into the future. The environment has changed significantly and a new look at the system is necessary as we move into the 90s.

Third, it is also necessary to note that the statistical evidence against the norms is strong. Recent stud ' ies have shown that if the relevant key financial ratios for RBI sample companies are taken and analysed, it is found that a large number of observations are many standard deviations away from the mean. In other words, statistical distributions are too flat and the reality seems to be that almost every company has uniqueness about i4 and, it needs to be treated as such (Singh, Bhattacharyay, 1989). Moreover, even in the area of management philosophy, the approach towards management of working capital is moving away from norms and models to strategic choices (Singh, 1988).

Fourth, it is also necessary to realise that banking and finance have all over the world also undergone a sea-change during the 80s. The major idea underlying the new environment is deregulation and consequently greater reliance on market mechanisms. The business world has grown weary of the edifice of controls engineered by the economists and the. planners to achieve better allocation of resources and better rates of growth. It is felt that they are tending to become counterproductive. The new wave is against micro-level controls and there is demand for the central monetary authority keeping only eyes on but hands off. As a matter of fact, a stage has come when bypass banking is tending to overtake regulation engineering. As the new environment is beginning to develop, disinter mediation and securitisation are growing resulting, in the development of new options for raising finance by industry, and they promise lower costs of funds.

New Developments

Recent developments have interesting features. They imply more competition among banks, breakdown of the concept of commercial banking and movement towards diversified banking. They also imply activation of money and capital markets, development of new financial products and services all leading towards lower costs of funds. But what is most important to note is that these developments bring in the creditworthiness to the centre of the stage. They are based on more disclosure, more transparent and clean balance-sheets, better information systems and better rates for higher credit rated borrowing companies.

It may be useful to highlight some of the basic elements of the new approach before the current Indian scene is examined in detail. There is now a distinction emerging between the operating and the financing side of financial management in the corporate sector. The operating side includes better management of inventories and

book debts. But what is new is the emergence of the role of the money manager or the treasurer on the financing side, and a larger and sharper focus on the management of the cash flows. It appears that the emphasis is shifting from economics to finance. It also appears that the treasurer's or money manager's office is tending to become a separate profit centre in its own right.

This shift away from variables of assets and liabilities towards variables of cash flows can easily be seen as the expansion and partition of the cash flow matrix. The conventional matrix for cash flow management is given in Exhibit 1. It provides for planning and control of various items of receipts and disbursements of cash under separate heads for different planning periods based on weekly, fortnightly or monthly columns. Each quantity entering into this matrix has three attributes: the magnitude, the timing, and the uncertainty; and, a number of assumptions regarding sales, purchases, production, credit plans and policies. One purpose of the exercise is to forecast the cumulative cash gaps for each period. Depending upon the algebraic signs they take, they represent either surpluses or deficits, or cash gaps. The other purpose of the subsequent managerial process is to improve the bottom line by changing magnitudes, timings, uncertainties, by changing underlying policies and practices relating to the management of the working capital, in essence, the inventories, credit and collections, or, the operating cycle.

The Indian scenario has been changing. The practice has, in recent years, undergone significant changes. In the early 70s when the rates of interest for lending to the corporate sector were in one go almost doubled, the general practice changed over to avoid credit balances in current deposit accounts. As the interest rates jumped up from about 8 or 9 per cent to 17 or 18 per cent, it was considered unwise to maintain credit balances in current accounts because they did not earn interest.

However, towards the end of the 70s after experiencing two credit squeezes, the corporate finance managers started lamenting the loss of financial flexibility arising out ofcomplete dependence upon commercial banks for filling their cash gaps. Therefore, with early 80s the tendency to draw whenever possible money from banks and to keep credit balances in current deposit accounts again came back into practice. And, in later half of the 80s as new opportunities started emerging, the corporate finance managers started parking their temporarily idle cash balances for earning interest revenue on them with a view to minimising the interest burden on their companies. Moreover, this also coincided with the emergence of many cash-surplus companies on the scene which were all set to take on to the new developments.

What has really happened is that the traditional matrix has got expanded and partitioned into two matrices. The second matrix is given in Exhibit 2. It starts with cumulative cash gap and moves on to current account balance, short-term borrowings from banks and the market, drawing power from banks, and, investment in money market instruments or other short-term quick assets coming under the purview of money manager. They include management of cash collections and payments and float to improve the bottom line and parking of idle funds to earn money on money.

It appears, in future, the focus in the area of financing the working capital in India would not only be on current assets, current liabilities, net working capital, and the current ratio. There will also be another major area of focus: the bottom-line and the portfolio of investment in quick assets. This would make quick ratio not only relevant

but also important for a large number of companies, and, that is what makes the situation formally bifocal.

Towards New Scenario

During the second half of the 80s, the national policies in India were modified with a view to liberalising regulations and to activate capital and money markets. Trends towards greater financialisation of savings and greater securitisation of financial assets have already started. With the activation of the capital market, larger volume of funds are being raised through debentures, and many debenture issues are being made, specifically to make more funds available for financing working capital. Many public sector units also raised funds through bonds. The corporate sector, in general, has been more active in raising, funds through public deposits as well. The current regulations restrict the amount of funds that ran be raised by a company by way of public deposits. As it has already been argued earlier, a part of the investment in working capital assets is always of long-term nature. Recent attempts to raise funds for financing working capital through public deposits and through bonds and debentures in the capital market although relatively few in number, are in the right direction because they strengthen the net working capital position and, therefore, improve creditworthiness of the concerned companies and also bring down the over-all cost of funds. As it happens, interest rates on short term borrowings in India are still higher compared to the rates prevalent for long-term borrowings.

Recent changes in the short-term money market are more significant for raising the working capital finance. With passage of time, most of these recent developments are likely to assume great significance during the 90s. The way things are developing, it appears that the exclusive dependence of the Indian companies on commercial banks for financing their working capital will, in large number of cases, no longer be necessary.

There is a healthy trend towards better management of cash movements and money manages position is gradually being involved. Although, only a few companies have got themselves involved thus far, serious attempts have been started to decentralise cash collection and to speed up collection with the help of services provided by some of the banks in the country. This is meant to reduce the float and improve the bottom-line of the cash flows. Further, attempts are also being made to streamline the working capital management and to reduce the need for working capital finance. Focus: the first matrix. But what is more important is the growing active interest in generating cash surpluses and parking them in short-term investments as and when they are available. These attempts lead to faster recycling of funds, reduction in need for borrowing and lowering of the interest burden. Focus: the second -matrix, demanding policy and operational decisions on all rows.

With a view to activating the money market, the banking system in India has introduced two new instruments. Treasury bills and commercial bills are already available. To these certificates of deposits issued by commercial banks and commercial paper issued by the corporate bodies have been specifically for use by the corporate sector. The certificates of deposit provide an opportunity to the corporate manager to raise short-term funds in the money market. The Reserve Bank has issued guidelines for issuing the two new money market instruments. These guidelines are

highly restrictive in character because the eligibility criteria have been set too high. There have been some subsequent liberalisation too. It is expected that as the experiment succeeds, the eligibility criteria will be further liberalised to permit larger number of companies to use CDs and CPs. It is also expected that the variety and range of instruments would also widen, and the secondary market would get itself established.

In this connection, it is relevant to point out that the basic idea underlying the introduction of new money market instruments and supportive new financial services, is to enable the corporate sector to raise funds more easily, to use funds already available more effectively and to reduce the interest burden. An active money market is meant to provide short-term funds at rates of interest much lower than long-term rates of interest. Treasury bills are, to some extent, used but only by the banks. They themselves also accept term deposits for short periods. In these cases, the rates of interest have fluctuated around 8 to 10 per cent. It is expected that under ideal conditions these should be the rates around which short-term money market in India should fluctuate. A prime rate would emerge and the CDs and CPs would also get related to it.

It is no doubt true that the Reserve Bank is overcautious. It is also not yet ready to exercise control over the monetary system if new developments pick up fast. All its control instruments and policies were developed in the past to meet the then prevailing conditions. It will have to review its own working and devise new control measures. This is what in the new environment, is called re-regulation. With more freedom available to banks, as well as players on the other side of the market it will be necessary to change regulations so that non fund and off the balance sheet business of banks and all other financial institutions can be regulated to achieve the national objectives.

For this purpose, some of the old ideas may have to be drastically revised. For example, it is not necessary to look at new money market instruments in the Tandon Committee perspective. It is no doubt true that more active use of CDs and CPs would drastically alter the nature of other current assets and current liabilities on corporate balance-sheets. That would demand a major reconsideration of the present system. But it is not wise to link operations relating to new money market instruments to maximum 'permissible bank finance or not to permit revolving underwriting arrangements and instead, permit only standby agreements within the credit limit sanctioned by the banks. In other words, it will have to be understood that if new developments are to be encouraged in the 90s, one cannot restrict them by the wisdom of the 70s.

There is the other side of the picture; it is also necessary to take note of the developments beyond the official market. What has really been happening in the unofficial market in the last few years is somewhat dysfunctional. The first major development in the market was the emergence of the financial service called portfolio management. Since the Reserve Bank regulations did not permit, it emerged as a sort of bypass banking. It was not prohibited either. Some banks started offering interest rates around 12 per cent to the corporate sector for their cash surpluses. The money was invested in either UTI units or public sector bonds and the banks made some

profit for themselves. To ensure absolute liquidity, the banks signed buyback agreements with their corporate clients. This meant reward without risk and also a more than normally expected reward on short-term deposits in India. The RBI prohibited portfolio management for periods shorter than a year.

Another most important development has been the removal of the ceiling of 10 per cent interest rate for the call market. Therefore, the call rates have on many occasions risen too high touching sometimes even 50 per cent and more. It is expected that the rates would somewhat stabilise in the near future, as the banks get used to the new game. There are, however, some banks and also some corporate money managers and private matchmakers who believe that in a country like India, demand and supply position of money is likely to keep the rates in the call market often times as high as 30 or 40 per cent. They are gearing themselves up for business opportunities under such conditions. In recent months, things have gone to the extent that some corporate money managers have availed credit facilities from some commercial banks at 16 per cent and through matchmakers lent them back through commercial banks at 30 or 4O per cent to other commercial banks. The matchmakers have also been busy in arranging inter-corporate short-term borrowings and lendings at rates above 20 per cent. In such transactions, commercial banks have also been involved. On the other hand, discounting of commercial bills which carry interest rates lower than 15 percent has not been so popular because the rediscount rates have not been higher.

These two parallel developments described above are apparently contradictory. On the other hand, the authorities at the national level have been trying to deregulate, to activate money and capital markets, to introduce new money market instruments in the expectation that money market would offer opportunities to the corporate money managers and banks to do more business and earn reasonable profit and, at the national level, to raise more funds in the market at reasonable cost of funds. On the other hand, the matchmakers in the market are using the new freedom to arrange inter corporate borrowing and lending, lending surplus funds to banks to meet their cash reserve requirements and to continue the short-term portfolio management service by replacing buyback arrangements with forward purchases. There have been several occasions in the recent past when liquidity in the market was tight and several companies have been made fabulous profits through such transactions, and, these profits have been earned through totally risk-free transactions. They cannot be considered functional.

The situation is, therefore, paradoxical. There is the hope that gradually things will, in due course, settle down and both the banks and the corporate money managers will start using available instruments and play the game within the guidelines and the policies of the Reserve Bank and help in achieving the national objectives. There is also the fear that the new environment might promote more of bypass banking, and ultimately, the experiment in freeing the call market rate may have to be considered a failure.

As against this, it might be noted that many Indian companies with the help of commercial banks have been gaining access to foreign funds raised in international money markets through the issue of commercial paper at fairly low rate of interest.

This not only makes cheaper funds available to the Indian industry but also helps in bridging the foreign exchange gap.
All innovations in financial world get popularised with passage of time. As attempts in India are being made to broaden the range of options available to corporate managers to finance their working capital through more deregulation, disinter mediation, securitisation, institutionalisation, and internationalisation, it should be recognised that to begin with only a few companies and a few banks would be involved. As these developments proliferate, with passage of time, the number of players and the variety of instruments will increase. This hope will materialise only if the introduction of instruments like CDs and CPs becomes popular both in the banking and in the corporate world. If they are pushed aside by somewhat clandestine and bypass banking in which the name of the game will only be making money on money, the bus will be missed. Much would depend upon whether the money game is played as chess or poker.

Bill Discounting - An Avenue For Retail Investors Too
Bill discounting is a short tenure financing instrument for companies willing to discount their purchase / sales bills to get funds for the short run and as for the investors in them, it is a good instrument to park their spare funds for a very short duration.
A lot of people believe that bills discounting falls in the purview of banks and financial institutions. While this may be correct to a large extent, it is also true that most of the smaller value bills of big corporates and smaller, but sound, companies is undertaken by retail investors, who have funds to spare for a certain period.
Bills discounting is of two types
1. Purchase bills discounting and
2. Sales bill discounting.

A purchase bill discounting means that the investor discounts the purchase bill of the company and pays the company, who in turn pay their supplier. The investor gets his money back from the company at the end of the discounting period.
A sales bills discounting means the investor discounts the sales bill of the company and pays directly to the company. The investor gets his return from the company at the end of the discounting period.
Funds *The funds generally required for this type of transaction start from Rs300,000 to upto Rs2mn. The tenure, generally, ranges from 60 days to upto 180 days.*
Procedure *The procedure is that a broker will contact you with proposals to discount bills of different companies at different rates of discounting. The better companies command discounting rates of 13% to 15%, while the lesser known, by size and by safety, have to pay discounting rates of 17% to as high as 28%. It is later explained what factors determine the discount rates. When an investor and the company agree to a particular bill discounting transaction, the following is what the company gives to the investor:*
The original copies of bills to be discounted;

A hundi / promissory note; Post dated cheque.
The investor simply has to issue a cheque. The amount of cheque is arrived at after deducting the discount rate. The post-dated cheque that the company gives is of the

full amount of the transaction. This can be better explained with an example as follows.
Company A wants to discount its purchase bill of Rs200,000 for a period of three months. Investor P agrees to do so at a discount rate of 21%. The deal is mutually agreed. Now, the investor will issue a cheque of Rs189,500.This figure is arrived at as follows:

= 200,000 x 21% x 3/12

Thus the investor gets his/her interest before the end of the period on discounting.The company on its part will issue a post-dated cheque of Rs200,000 for three months period.

Here we see that the investor benefits in two ways:
He gets the interest element at the first day of issuing the cheque. i.e. he does not include that part in his cheque amount. Thus he can earn interest on this interest for a three-month period. Even a simple bank fixed deposit on it will earn @5% p.a. By investing Rs189,500 for three months, the investor earns Rs10,500 on it. A return of 22.16%.
Discount Rates *The rates depend on the following factors:*
The Broker: The broker has a good influence on the rates offered by companies. His relations with the company and the investor do make a difference of a couple of percentage point in discounting rates.

Market Liquidity: Liquidity crunch in the market tends to hike up the rates even in the best of the companies. Since this instrument is a short tenure one, short-term changes in the market liquidity greatly affect the discount rates.
Volume/Value of Discounting: When the volume/value of discounting done by the investor is high, he is looking at security more than returns. The company on its part is looking at savings by way of reduced legal paper work and a higher amount of dedicated funds for a said period and hence on the whole reduced costs to the company.

Frequency: An investor who is regular bills discounter for the company may get upto 1% to 1.5% points higher interest rates than a new investor. As for the investor he is trying it out with a new company and will agree to a lesser rate to ensure safety.
Company's finance resources: This is one of the biggest factors that decide the discount rates. A Public limited company generally tends to have a cheaper source of finance as against any other form of company. Working capital financing of companies to a large extent manipulates the rates the companies are willing to discount their bills at**Caveat**

The following points need to be remembered when dealing in this instrument.
One must have a thorough knowledge of the company whose bills are discounted. Their industry, competition, people at the helm and their reputation in the market. This is necessary as it is going to be the company that is going to pay you from its earnings.
There is no legal fall back option in case of default by the company. The company does sign a promissory note, but legal respite using this will take years to happen. The

investor is not a secured creditor for the company nor does he get any preference on winding up of the company.
Brokers need to be people who are well known to you. Since most of the deals happen through them, you should know the broker well enough to trust him and his deals. Spurious brokers are plenty out there in the market and a watchful eye must be kept. Even after investing in the company a regular watch on the company's fortune and a constant touch with the broker would be warranted.

RBI tightens norms for bills discounting

THE Reserve Bank of India has permitted banks to sanction limit for bills discounting to borrowers in accordance with the loan policy as approved by their board of directors.
In its guidelines on discounting and rediscounting of bills by banks, based on the recommendations of the working group on discounting of bills by banks, the RBI has said banks should lay down a bills discounting policy approved by their board of directors and consistent with their policy of sanctioning of working capital limits.
In a circular issued to all scheduled commercial banks, the apex bank has said the procedure for board approval should include banks' core operating process from the time the bills are tendered till these are realised.
Banks should open letters of credit (LCs) and purchase, discount, negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks.

Therefore, banks should not extend fund-based (including bills financing) or non-fund-based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or a non-constituent member of a consortium, multiple banking arrangement.
While purchasing, discounting, negotiating bills under LCs or otherwise, banks have been asked to establish genuineness of underlying transaction documents.
Accommodation bills should not be purchased, discounted or negotiated by banks.
Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.
Bills rediscounts should be restricted to usancebills held by other banks. Banks should not rediscount bills earlier discounted by non-banking financial companies (NBFCs) except in respect of bills arising from sale of light commercial vehicles and two-/three-wheelers.

Banks may exercise their commercial judgment in discounting of bills of services sector. In order to promote payment discipline which would to a certain extent encourage acceptance of bills, all corporates and other constituent borrowers having turnover above threshold level as fixed by the bank's board of directors should be mandated to disclose `aging schedule' of their overdue payables in their periodical returns submitted to banks.
Banks should not enter into repo transactions using bills discounted/rediscounted as collateral. Banks should follow the above instructions strictly and any violation of these instructions will be viewed seriously and invite penal action from the RBI.

Banking : Tightening the noose HISTORY has shown that banking crisis are followed by reforms. Bankers expect history to repeat itself in the forthcoming monetary policy.
Investigations into the Madhavpura Co-operative Bank episode have shown that stock brokers have misused the Ahmedabad-based cooperative bank's funds to the extent of Rs 1000 crore.

This includes the Rs 800 crore lent to stock broker Ketan Parekh and Rs 200 crore to Mukeshbabu by Madhavpura Cooperative Bank. Fallout of this is expected to be RBI measures aimed at curbing such violation of norms. But it is unlikely that any dramatic changes on bank's capital markets exposure would be announced in this policy. The central banks have always debated major policy changes with senior bankers before implementing them. A draft report on bank's exposure in the capital market was circulated last week and comments from banks are expected only in May.
But in the short run, RBI is expected to announce fine turning of some of the existing prudential norms. Some bankers feel that the central bank will tighten norms in respect of the maximum conuter-party exposure in inter-bank deals.
It is also likely that the RBI will take the first step towards introducing risk based supervision In the last two credit policy, RBI has expressed its intentions to move towards RBS.

RBS would imply monitoring banks by allocating supervisory attention according to the risk profile of each institutions. It would be done by upgrading the supervisory tools like on-site and off-site inspections and putting in place market intelligence mechanism. Besides this, several other draft reports which have been circulated and largely debated could be notified in the forthcoming policy. These include a draft guideline credit exposure limits which suggest broadening the definition of net worth and thereby permitting higher loan exposure limits to individual and group accounts.
There are draft norms on strengthening the bills discounting mechanism and extending it scope to service sector, a paper on pre-empt corrective action which will enable RBI to pre-empt any deterioration in the banking system.

HOUSING FINANCE

LESSON OBJECTIVES: TO UNDERSTAND THE CONCEPT OF HOUSING FINANCE.
KNOWLEDGE OF HOUSING FINANCE SCHEMES AND WORKING OF HOUSING FINANCE COMPANIES.

INTRODUCTION:

In the country development of housing finance started very late. Initially it was the responsibility of government to provide the finance in this sector, as there was no initiative from private sector. The setting up of National Housing Bank (NHB) a fully owned subsidiary of the RBI in 1988 as the apex institution, marked the beginning of the emergence of housing finance as a fund-based financial service in the country. Since than, it has grown both horizontally as well as vertically with the entry of specialized financial institutions / companies in the private, public and joint sectors.

Real growth of housing finance sector was witnessed in last five years, due to rapid reduction in interest rates and governments efforts to boost housing infrastructure. Also, growth was propelled because of Income Tax benefit available on housing loans to individuals.

HOUSING FINANCE SYSTEM

The implementation of housing finance policies presupposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance to individuals for house construction, there was no well established finance system till the mid eighties in as much as it had not been integrated with the main financial system of the country. The setting up of the National Housing Bank as a fully owned subsidiary of the RBI as an apex institution was the culmination of the fulfillment of a long overdue need of the housing finance industry in the country. The system has been characterized by the emergence of several specialized financial institutions which have considerably strengthened the organization of the housing finance system in the country. In last few years, various companies have jumped into the field of housing finance, but major business is with few well recognized companies only.

Now let us look into the system of housing finance and discuss few of the important organizations in the system.

Central and State Government

Till the mid-eighties, the responsibility to provide housing finance rested by and large with the government. The Central and State governments support the housing / building efforts indirectly. The Central government has introduced, from time to time, various social housing schemes. The role of the Central government vis a vis these schemes is confined to laying down broad principles, providing necessary advice and rendering financial assistance in the form of loans and subsidies to the state

governments and union territories. The Central government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and urban development programme, development of land for satellite towns, besides setting up of building material industry.
The Central government provided equity support to HUDCO and guarantees the bonds issued by it. Apart from this, both Central and State governments provide due house building advances to their employees. While the Central Government formulates the housing schemes, the state governments are the actual implementing agencies.

Housing and Urban Development Corporation (HUDCO):
HUDCO was established on 25th April 1970 as a fully owned government enterprise with following objectives:

(i) To provide long-term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country.
(ii) To finance or undertake the setting up of building materials industries.
(iii) To finance or undertake the setting up of new satellite towns.
(iv) Administer the moneys received, from Government of India or other such grants for purposes of financing or undertaking housing and urban development programmes.
(v) To subscribe to the debentures and bonds to be issued by the state housing boards, improvement trusts, development authorities and so on, specifically for the purpose of financing housing and urban development programmes.

The HUDCO was established with an equity base of Rs. 2 crore. Over the years, the Government has expanded the equity base. It has further been able to mobilize resources from institutional agencies like LIC, GIC, UTI, commercial banks, international assistance as well as through public deposits.
The HUDCO provided assistance benefiting masses in urban and rural areas under a broad spectrum of programmes like rural & cooperative housing, urban employment through housing and shelter development, land acquisition, basic sanitation and environmental improvement of slums, consultancy for technology transfer, building material industry and building technology.
The HUDCO has also been entrusted with the responsibility to finance urban infrastructure projects with additional equity support provided by the Ministry of Urban Development, Government of India. The infrastructure projects cover sectors of water supply, sewerage, drainage, solid waste management, transport nagars/ terminals, commercial – social infrastructure, road, bridges and are development projects and so on.

Insurance Organizations / Corporations:
The LIC and GIC support housing activity both directly and indirectly. The LIC is statutorily required to invest 25 percent of the net accretion of funds in socially oriented housing, electrification, water supply and so on. Besides subscribing to bonds of the HUDCO and state housing boards, LIC grants loans to state governments for their rural housing programmes and to public sector companies for construction of

staff quarters. Though LIC has been granting loans to individuals, directly, the thrust to housing finance was provided when, in 1989, the LIC promoted a subsidiary for the purpose, namely the LIC Home Finance Ltd.
The GIC and its subsidiaries are required to invest 35% of their annual accretions by way of loans to socially oriented schemes such as housing. It supports housing almost exclusively indirectly by subscribing to bonds/debentures floated by the HUDCO and state housing boards. It has also set up a housing finance subsidiary called the GIC Housing Finance Ltd., in July 1990 to enable it to lend directly to individuals.

Commercial Banks:
Commercial banks lending to individuals for housing emerged in the wake of the report of the working group on Role of Banking System in Providing Finance for Housing Schemes. They have been lending to the housing-sector based on annual credit allocations made by the RBI.

Cooperative Banks:
The cooperative banking sector consists of State Cooperative Banks, district central cooperative banks and primary urban cooperative banks. The RBI issued the first set of comprehensive guidelines, for these cooperative banks, in 1984. Cooperative banks finance individuals, cooperative group housing societies, housing boards and others who undertake housing projects for EWS, LIGs and MIGs.

Specialized Housing Finance Institutions:
There are certain institutions termed as 'Specialized HFI', which cater only to the needs of the housing sector. They can further be classified as housing finance companies promoted in the public / private / joint sectors and cooperative housing finance societies. A lead player in HFC category is the HDFC Ltd. It lends, mainly for new residential housing to individuals, groups of individuals, and individual members of cooperative societies.
Besides the HDFC, a number of HFCs have been sponsored by banks such as SBI Home Finance Ltd, Canfin Homes Ltd, IndBank Housing Finance Ltd, Citihomes etc.

HOUSING FINANCE SCHEMES:
To cater to the diverse needs of housing in India, the HFIs / HFCs have tailored a variety of housing finance schemes. Let us discuss, in short, salient features of these schemes.
Housing Loan Schemes of Commercial Banks:
As observed earlier, 1.5 percent of incremental deposits of commercial banks have to be made available to the housing sector every year. These have to be done in accordance with RBI guidelines. The housing loans/ finance are provided to individuals, institutions, public agencies, and so on. The salient features of housing finance schemes of commercial banks are as following:

Loans to Individuals: Individuals eligible for housing loans fall into four categories, namely, those belonging to economically weaker section/ low, middle and higher income groups; those owning land and capable of liquidating the loan within stipulated time; those purchasing residential flats from state housing boards/

improvement trusts / cooperative societies / private builders and others and those belonging to SC/ST, who have been allocated land by the government.
The rate of interest is charged according to the amount of advance and RBI PLR. The SC/ST borrowers have to pay concessional rates on housing loan. Normally commercial banks do not pay full cost of the house and the owners/borrowers have to bring in the margin money. Normally margin money is 25% of the cost.

The amount of loan depends on the capacity of the borrower to repay and the cost of construction, subject to a maximum limit of Rs. 10 lakh.
Repayment of the loan has to be done in equal monthly installments within a maximum period of 15 years. Initial moratorium of 18 months or until completion of construction whichever is earlier may also be allowed. The normal security for the housing loan is mortgage of property purchased from the proceeds of the loan. However, where it is not feasible the banks may accept security of adequate value in the form of life insurance policies, Government promissory notes, shares and debentures, gold ornaments and such other securities.
Banks also entertain supplementary finance for repair/alterations/ additions to the house / flat/ building already financed by them.
Loans to Institutions / Public Agencies by Commercial Banks: This can be further classified into four categories:

Term loans to housing finance institutions: HFIs can avail of term loans from banks. The quantum is determined on the basis of debt equity ratio, track record, recovery performance and other relevant factors. In no case, the quantum of term loans to be granted to the HFC/ HFIs together with the outstanding loans in the existing term loans from the banking system should exceed their NOF. This norm is however, relaxable in the case of HFC/ HFIs promoted /sponsored by commercial banks as also in respect of the HUDCO and HDFC.

Lending to Housing Boards and other Agencies: Banks may extend term loans to state level housing boards and other public agencies on the same terms and conditions as indicated in the case of HFIs. Banks, however, look into the past performance of such boards in recovering the installments from beneficiaries and also stipulate that the boards ensure prompt and regular recovery of loan installments from the beneficiaries.

Financing for Land Acquisition: Banks grant loans to public agencies for acquisition and development of land provided it is a part of the complete project including development of infrastructure such as water system, drainage, roads, provisions of electricity and so on. The maximum period of repayment is three years if project also covers construction of houses. Credit extended to individual beneficiaries should conform to the terms and conditions applicable to individual borrowers.

Loans to Builders: Builders who wish to avails of credit for development of plots coupled with the construction of flats/houses under refinance scheme of the NHB are granted loans by the banks, subject to certain conditions like

(i) The loan amount in respect of at least 75% of the dwelling units (flats/houses) should not exceed Rs. 3 lakh per individual unit.

(ii) Builders' own contribution should not be less than 25% of the cost of the project which is to be brought in first and used before disbursement of bank loan.
(iii) The bank loan is in the shape of term loan for a period of three to five years linked to each specific project. The finance is made available for the completion of the project which includes construction of the dwelling units.
(iv) The dwelling units should be sold through open advertisement, to the prospective buyers at the predetermined prices to avoid speculation.
(v) On completion of the project, the dwelling units should be sold on outright sale basis to allottees who may avail of loans from banks.
(vi) Sale proceeds are to be utilized by builders strictly for repayment of the term loans given to them by the banks.

SBI HOME FINANCE – HOUSING FINANCE SCHEMES

The SBI Home Finance (SBIHF) provides housing finance to individuals, corporate bodies and promoters and developers. The main features of these schemes can be classified as following:

Housing loan Schemes for Individuals: SBIHF sanctions loans to individuals for construction of houses, purchase of houses / flats and repairs, renovation, addition alteration extension etc. The loans are sanction for a period ranging from 5 to 20 years, up to Rs. 10 lakhs based on the repayment capacity of borrower.

Schemes for promoters and developers: The purpose of housing loans given to this category of borrowers is an additional source of finance to supplement their own resources, for construction of residential housing projects. Maximum limit of loan amount is 50% of the project cost or balance required for completion of the project. Repayment is normally done in three years in suitable installments, based on the cash flow of the project.

Schemes for Corporate: The SBIHF has designed three alternative schemes for lending to corporate bodies: (a) for construction / purchase of staff quarters for their own employees, (b) for on-lending to their employees in accordance with their own housing schemes and (c) loans to their employees nominated by them. The upper limit in all the three schemes is Rs. 5 lakh for each individual dwelling.

HDFC SCHEME FOR INDIVIDUALS:

The HDFC advances housing loans to individuals for (a) buying or constructing houses, (b) extension or improvement of existing houses, (c) acquiring a self-contained flat in an existing or proposed cooperative society/ apartment owners association and (d) independent bungalow / row house. Loan can be availed of up to a maximum of 85% of the cost of the property including the cost of land. The maximum loan to an individual can be Rs. 25 Lakh. Although the equated monthly installment of repayment is over 15 years period, the repayment does not ordinarily extend beyond the age of retirement or 65 years of age of the borrower, whichever is earlier.

GLOSSARY - HOUSING LOAN

Acceptance Letter: The letter that a borrower eagerly waits to fill up. Once the loan is issued by the way of sanction letter, the applicant communicates his willingness to accept the loan by way of an acceptance letter. He has to send this within a time frame of 1-3 months from the date of the sanction letter.
Advance EMI: Pay back time! Number of equated installments in the form of post dated cheques, paid out in advance at the time of disbursement of loan.
Administrative Fee: Unavoidable pay out by which bank/HFC can make money of you. A one time fee; generally non-refundable; payable before the loan is disbursed. Rates may vary from 1-2% of the loan amount.

Close Relatives: As per the section 6 of the company act, a close relative is one who is acceptable as a guarantor is any of the following: Father, Mother (including step mother), son (including step son), son's wife, daughter (including step daughter), son's son, son's son's wife, son's daughter, son's daughter's husband, daughter's husband, daughter's son, daughter's son's wife, daughter's daughter, daughter's daughter's husband, brother (including step brother), brother's wife, sister (including step sister), wife/husband and sister's husband. However they should comply with the age and other norms of the company to be considered as guarantors.

Commitment Fee: Much like other commitments, which if one screws up one gets the short end of the straw? It is an interest, which is charged if you do not draw the sanctioned loan amount within a period of 6-7 months. The interest rate is usually about 1-2%.

Credit Appraisal: The IMPORTANT PEOPLE! Every Housing Finance Company (HFC) has its own panel of credit appraisal officers who process applications. They take into account various factors like income of the applicants, number of dependents, monthly expenditure, repayment capacity, employment history, number of years service left over and other factors, which affect the credit rating of the borrower. Proof of income will also be verified for the purpose of approval of loan. The time taken for receipt of such information is crucial since it affects the length of time required for a loan approval.

Documentation: Documentation is the papers to be signed in connection with the loan at the HFC,i.e.the loan papers.
Down Payment: Wonder why it's called down payment when it has to be paid up-front? Housing Finance companies normally give loans up to 80-85% of the value of the property. The balance would have to be paid by the buyer, as a payment before he draws on the loan amount.

Encumbrance: Document to ward of the nightmare of property litigation. It records details of transfer of ownership of a property in succession right to the current owner. It shows the date, the names of the parties involving the amount of consideration, the extent and schedule of the property. This certificate can be obtained from the sub registrars' office for a payment of fee. This certificate is also useful in establishing the events as to how and when the present owner came into possession of the property.
Equated Monthly Installment (EMI): Loan repayments are usually in Equal Monthly Installments over the tenure of the loan. Some banks also offer a Variable Installment

Scheme in the beginning of the loan period. This is beneficial for those individuals who are trying to maximise their tax breaks in the initial years and expect future tax breaks to fall

Exposure/Extent of loan: The loan amount as against the value of the asset/product. Try avoiding an indecent exposure; it's better for your health as well!
Floating Rate: Here the interest rate on the loan depending on the Prime Lending Rate (PLR) fixed by the Reserve Bank. This change can happen as frequently as one in six months. If the PLR falls, you benefit and if it rises... However, in case of a fall your payments remain the same for every month. The finance company will refund some of your EMI cheques and effectively compensate you by reducing the tenure of the loan. The reverse happens if the PLR rises, much to your disadvantage. Whoever said that this is a floating rate has got be joking. It's best called the sink or ride the crest rate, wouldn't you agree?

Flat Rate: Percentage representation of the amount of annual interest on the total loan amount.

Interest Tax: Housing Finance companies have to pay a tax on the interest income they receive. One should check whether the interest rates quoted include interest tax or not. This tax is normally about 2% of the interest rates charged. Interest tax has been abolished from April,2000 .

Interest Rate: Rate at which the lenders charge interest for the loan amount.
IRR: Internal Rate of Return is the rate at which the lender accounts for interest.
Legal Scrutiny Report: The documents which are pertaining to your property needs to be scrutnised by the legal personnel of the HFC to ensure that you are buying a property that is clear and marketable.
License for Construction: This is basically permission to construct or an authorization in writing issued along with the loan application.
Margin Amount: Margin Amount is the difference between the total cost of the project and the loan amount sanctioned. This money has to be invested by the borrower prior to the release of the loan amount.

Marketable Title: A person is said to have a marketable title only when the title to the property is clear and he/she has the right and capacity to transfer the same.
Market Value: This is the value of the property as per the prevailing market value.

Obligation: The borrower in terms of the agreement will be obligated to keep up the schedule of repayment to deposit the post dated cheques periodically and to keep the property free from encumbrance.

Prepayment Charges: Most HFCs charge some fee for pre-payment of loan before the tenure is over. Your earning capacity normally increases with your age and a pre-payment fee can be a big cost. The fee is normally in the range of 1-2% of the pre-paid amount.

Pre-Sanction Inspection of Property: After the receipt of the loan application, a loan officer from the HFC conducts an inspection of the property to ascertain the location of the property, verify the technical details of the house and the stage of construction.
Property Tax: This is the tax which is levied by the local authority such as Corporation, Municipality etc. to the person in whose name the property stands.

Refinance Charge: Home Housing Finance companies do not charge you for prepayments from your own savings. However, if you retire a loan using money borrowed from another Finance Company, you will have to pay a refinance charge of 1-2% of the loan outstanding.

Registration Value: This is the value of the property at which the property is registered.

Role of Guarantor: The role of a guarantor is commitment by the way of agreeing to the terms and conditions of the loan and liable to the extent of the loan/liability together with the interest and other charges.

Rest: A contradictory word here as it does nothing but increase your tension. Interest rates are quotes on a daily rest, monthly rest or annual rest basis. The annual rest quote implies that the company gives you the credit for the monthly principal repayments only at the end of each year. Such loans are therefore more expensive than a monthly/daily rest loan. The shorter the tenure of the loan, the greater the effective interest rate difference will be.
Sale Agreement: Sale Agreement is an agreement which is entered in between the parties dealing with the property and which creates a right to obtain a sale deed mentioning the property. Generally it precedes a sale deed and normally it fixes a time for completion, payment of earnest money or part payment of purchase consideration.

Sale Deed: This is an instrument in writing which transfers the ownership of the property/properties in exchange for a price paid or considered. This document is required to be registered compulsorily.

Sanction Letter: This is the letter which communicates the sanctioned terms and conditions once the loan is approved.

Sanctioned Plan: A drawing containing the plans, section of elevations of areas along with detailed schedules, specifications and area statements on which the sanctioning authorities grant permission to carry out work as regulated in the bye laws.

Stamp Duty: It is the duty/fee payable on the different instruments / documents as per the prescribed rate. The adequacy of stamp duty should be ensured to make a document valid and enforceable.
Statement of Account: The statement indicating the outstanding loan amount, the amount paid by the borrower, the appropriations made towards the interest and principal, etc. at the end of the financial year.

Tenure of the Loan: Normally, loans are given for a period of 1-15 years. Some companies also give loans up to 20 years at an additional interest cost of 0.25% - 0.5%.

HOUSING FINANCE SECTOR BOOMS AHEAD

12/16/2003, Source: TIMES NEWS NETWORK

That's not all. Banks are falling over themselves in a bid to capture market share. As a result, consumers now have plenty of choices from an array of innovative schemes. Also, the easy accessibility of loans has proved to be a catalyst in the upswing in real estate rates, particularly on the outskirts of metropolitan cities like Bangalore, Delhi and Mumbai over the past six months. We check out on the various home loan schemes on offer from various banks.

Super savers

In the case of some schemes from new entrants into the home loan retailing spectrum, the 'super saver' schemes are being offered at a rate of as low as 6% per annum for the first year, and 6.5% per annum for the second year. The scheme subsequently operates on a floating rate basis from the third year onwards, in line with the prevalent market rates. This effectively means that the consumer has to pay an equated market installment (EMI) of around Rs 842 per month per Rs 1 lakh borrowed in the first year, which goes up to around Rs 885 per lakh per month in the second year. From the third year onwards, the rate would on a floating basis, in line with the interest rate prevalent at that time. But in such schemes, there is a lock-in period before the consumer can opt to get the loan refinanced from another banker. The penalties are heavy too.

A variant of this scheme is for the lower income class, who expect an increase in their income in a year or two. Here, the EMI is Rs 660 or Rs 686 per month per lakh in the first year, which subsequently shoots up from the next year.

Split rates

As the name suggests, the amount borrowed from a bank is charged on a floating as well as fixed basis. Usually 40% or 20% of the amount of home loan is treated on a fixed rate of interest, while 60% or 80% is charged on floating rate basis. In case of floating schemes, rates are usually lower by around 50 basis points than in fixed rates. Thus, part of the rate-hike risk (20% or 40%) gets capped. But on the flip side, fixed rates (currently 8.25 %) are subject to be reviewed after three years.>

Convenience schemes

These home financing schemes are initiated by well known developers in pact with housing finance companies or banks. Under such schemes, customers can book the property to be developed by the construction company/developer by paying just 5% of the aggregate value of the property. For the remaining amount, the housing finance company/bank, which has already approved the project, gives a loan within one month of booking.

Since the loan is sanctioned in the name of the buyer but remitted to the developer at that point, the developer shares 65-70% of the EMI of the borrower till the property is

handed over to the buyer. The rest (one-third of every EMI for about two years) is paid by the borrower. This is effectively his cash discount payment.

The schemes are usually for 20-year terms only and cannot be foreclosed by the borrower. Thus, it is a win-win situation for the housing finance company, which gets EMIs for 20 years, as well as the developer, who gets a cash-down payment.

These schemes are ideal for those buyers of property, who want to make the most of the upcoming real estate boom, with a view of resale and minimum investment. For the real prospective users of property, such schemes are a costly proposition.

Floating/Fixed Rates

Apart from the above variants, normal floating and fixed rate schemes are also available. However, in most cases, fixed rate schemes are costlier by 50 basis points. There are standard processing/administrative charges of 0.5% of the loan, and the penalty for getting these refinanced are 2% of the outstanding loan amount. Prepayment from savings account is permitted without any charges, in most cases.

With competition heating up, it is up to the consumer to make the choice from among the available home financing schemes, since interest rates have come to a new low.

LESSON 16
HOUSING FINANCE: NHB, REGULATORY FRAMEWORK, REFINANCE

LESSON OBJECTIVES: TO KNOW THE REGULATORY FRAMEWORK FOR HOUSING FINANCE, UNDERSTAND THE WORKING OF NHB.

TO UNDERSTAND THE SYSTEM OF REFINANCE.

INTRODUCTION

The National Housing Bank, being apex body for regulating the housing finance, controls all housing finance institutions and companies. Let us study the NHB first to understand its working.

NATIONAL HOUSING BANK (NHB)

The NHB was established in 1988 under the NHB Act, 1987 to operate as a principal agency to promote housing finance institutions both at local and regional level, and to provide financial and other support to them. The HFIs include institutions, whether incorporated or not, which primarily transact or have as one of their principal objects the transacting of the business of providing finance for housing, either directly or indirectly.

The NHB is an incorporated body, with powers to establish it offices, branches and agencies at any place in and outside India (subject to RBI approval). Its is a 100% subsidiary of RBI with a fully paid up capital of Rs.350 crores. Its capital can be increased up to Rs. 2000 crores with a restriction that at least 51% of the paid capital will be held by RBI / Government / Public Sector banks or Public sector financial institutions.

The management of the NHB is with a Board of Directors, headed by the Chairman (or Chairman and Managing Director). The other members of the board are Two Directors, experts in any field which is useful for NHB, Two Directors, experienced in running financial institutions, Two Directors elected by shareholder, other than RBI/ Central Government, Two directors from out of the RBI directors, Three Directors from amongst the Central Government officials and Two Directors from amongst the State Government officials.

BUSINESS OF NHB

The NHB has the powers to get involved into various business activities, subject to provisions of NHB Act. Main activities of NHB are as following:

(a) Promoting, establishing, supporting / aiding in the promotion / establishment/ support of HFIs.
(b) Making of loans and advances or rendering any other form of financial assistance, whatsoever, for housing activities to HFIs, banks, state cooperative agricultural and development banks or any other institutions / class of institutions notified by the Government.
(c) Subscribing to / purchasing stocks, shares, bonds, debentures and securities of every other description.

(d) Guaranteeing the financial obligations of HFIs and underwriting the issue of stocks / shares / bonds/ debentures/ other securities of HFIs.
(e) Drawing, accepting, discounting / rediscounting, buying/ selling and dealing in bills of exchange/ promissory notes, bonds/ debentures, hundies, coupons and other instruments.
(f) Promoting/ forming/ conducting or associating in promotion/ formation/ conduct of companies / mortgage banks / subsidiaries/ societies/ trusts/ other associations of persons it may deem fit for carrying out all/ any of its functions under NHB Act.
(g) Undertaking research and surveys on construction techniques and other studies relating to / connected with shelter / housing and human settlement.
(h) Formulating scheme(s) for purposes of mobilization of resources and extension of credit for housing.
(i) Formulating schemes for economically weaker sections of society which may be subsidized by Government or any other sources.
(j) Organizing training programmes / seminars/ symposia on matters relating to housing.
(k) Providing guidelines to HFIs to ensure their growth on sound lines.
(l) Providing technical / administrative assistance to HFIs.
(m) Coordinating with the LIC, UTI, GIC and other FI in the discharge of its overall functions.
(n) Exercising all powers and functions in the performance of duties entrusted to it under the NHB Act or under any other law in force for the time being.
(o) Acting as agent of the Central / State Government/ The RBI or any authorities as may be authorized by the RBI.
(p) Any other kind of business which the Government may, on the recommendations of the RBI, authorize.
(q) Generally, doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under the NHB Act.

BORROWING AND ACCEPTANCE OF DEPOSITS:

For purpose of carrying out its functions, the NHB may

(a) Issue and sell bonds and debentures with or without the Guarantee of Central Government, ins such manner and on such terms as may be prescribed;
(b) Borrow money from the Central Government, banks, financial institutions, mutual funds and from any other authority or organization or institution approved by the Government on such terms and conditions as may be agreed upon;
(c) Accepting deposits repayable after such period and on such terms as may generally or specially be approved by the RBI;
(d) Borrow money from the RBI (i) by way of leans and advances and generally, obtain financial assistance in a manner specified by the RBI; (ii) out of the National Housing Credit (Long-term Operations) Fund established under section 46-D of the RBI Act;
(e) Receive, for services rendered, remuneration, commission, commitment charges, consultancy charges, service charges, royalties, premium, license fees and any other consideration of whatever description;

(f) Receive gifts, grants, donations or benefactions from the Government or nay other source.

The Central Government may guarantee the bonds and debentures issued by the NHB as to the repayment of principal and the payment of interest at rates(s) fixed by the Government.

POWERS OF NHB

Being an apex institution for housing finance, the government has given it exclusive powers in the NHB Act. A brief description of the powers is following:

Powers to transfer rights: The rights and interest of the NHB in relation to any loan/ advance made or any amount recoverable may be transferred by it wholly or partly in any form. Notwithstanding such transfer, the NHB may act as a trustee for the transferee in terms of Sct. 3 of the Indian Trusts Act, 1882.

Power to Acquire rights: The NHB has the right to acquire, by transfer/ assignment, the rights and interest of any institution in relation to any loan / advance made / amount recoverable wholly or partly by the execution / issue of any instrument or by the transfer of any instrument or in any other manner in which the rights and interest in relation to such loan/ advance may be lawfully transferred.

Power to recover dues as land revenue.

Power to impose conditions: To protect its interest, the NHB may impose any conditions on HFIs.

Power to call for repayment before agreed period: In order to protect its interest NHB can call for prepayment of loans from borrowing institutions.

Access to Records: The NHB has free access to all such records of the institutions / persons availing of any credit facilities from it, the perusal of which may be necessary in connection with the provisions of finance or other assistance to the institution / refinance of any loan/ advance to such person by the institution.

Power to inspect

Power to Collect and publish credit information.

PROVISIONS RELATING TO HOUSING FINANCE INSTITUTIONS:

Now let us discuss the provisions related to HFIs.

Registration and Net Owned Funds: To commence and carry on business, every HFI set up as a company should obtain a certificate of registration from the NHB and have net owned funds of Rs. 25 lakh or such higher amount as may be specified by the NHB from time to time.

Cancellation of Registration: The registration of a HFI can be cancelled by the NHB if it (a) ceases to carry on business, (b) has failed to comply with any condition subject to which the registration was issued (c) at any time fails to fulfill any of the conditions laid down for grant of registration (d) fails to comply with any directions by the NHB.

Maintenance of Percentage of Assets: At least 5 percent or such higher percentage, not exceeding 25 percent, as specified by the NHB from time of deposits outstanding at the close of business on the last working day of the second preceding quarter of a HFI should be invested in unencumbered approved securities valued at a price not exceeding their current market price.

Reserve Funds: A reserve fund should be created by the HFIs by transfer of a sum not less than 20% of net profits every year before the payment of any dividend.

Issue of Prospectus / Advertisement: If considered necessary in public interest, the NHB by general / special order – regulate / prohibit by any HFI of any prospectus / advertisement soliciting deposits from the public and (b) specify the conditions subject to which it can be issued.

Determination of Policy and issue of Directions: In public interest and to regulate the housing finance system of the country, NHB may determine the policy and issue direction, within the overall policy framework of the Government.

Collection of information about deposits and issue of direction.
Power of the NHB to prohibit Acceptance of deposit.
Powers to file winding up petition.
Powers to Inspection.
Power to order Repayment of Deposits
Power to appoint recovery officers for recovery of funds due to HFIs registered with NHB.

Power to impose penalties: In case any HFI fails to furnish or furnishes any wrong information, than NHB can impose penalties as per the provisions of NHB Act.
Power to make rules & Power of Board of Directors of the NHB to make regulations: In consultation with government and with prior approval of RBI, the NHB may make rules and regulations, not inconsistent with the NHB Act to provide for all matters for which provision is necessary / expedient for the purpose of giving effect to the provisions of the NHB Act.

NHB's HOUSING FINANCE COMPANIES DIRECTIONS

As the principal housing finance company, the NHB is authorized, in public interest, to give directions to housing finance companies, which primarily transact or have as their principal object the transacting of business providing finance for housing whether directly or indirectly. We discuss herewith, main elements of the NHB directions to HFIs.

Registration: Every HFC accepting public deposit, having minimum net owned funds of Rs. 25 lakh should be registered with NHB. The registration is subject to following conditions:

(i) That the HFC is/ would be in a position to pay its present/future depositors in full as and when their claims accrue.
(ii) That its affairs are not being / are not likely to be conducted in a manner detrimental to interest of its present/ future depositors.

(iii) That the general character of its management/ the proposed management would not be prejudicial to public interest / the interest of the depositors.
(iv) That it has adequate capital structure and earning prospects.
(v) That the public interest would be served by the grant of certificate of registration to it.
(vi) That the grant of certificate of registration would not be prejudicial to the operation and growth of the housing finance sector of the country.
(vii) Any other condition, fulfillment of which in the opinion of the NHB, would be necessary to safeguard the public interest or the interest of the depositors.

Acceptance of Deposits:
The HFCs can accept deposits from public, subject to NHB Act provision.
Public Deposits and Minimum Credit Rating:
Any HFC having NOF of Rs. 25 lakh and above can accept public deposits if it has obtained credit rating for fixed deposits not below Grade A from any of the approved rating agencies. The duration of deposit could be 12 to 84 months. In case credit rating of the HFC falls below Grade A, it is directed to stop immediately accepting fresh public deposits. It has to maintain a register of deposits with all necessary information about the deposit. An HFC with NOF of up to Rs. 10 crore can accept public deposit to the tune of 10 times its NOF. Each HFC has to pay interest on all the public deposits it accepts. The rate of interest cannot exceed the overall limit prescribed by the NHB from time to time.

Housing Finance companies can pay interest on overdue deposits. But this interest will be subject to provisions of the directions given by NHB. If the HFC fails to pay deposit along with interest on due date, it would pay amount along with interest on the overdue time portion of the deposit on a future date. NHB has also given direction for repayment of deposits. No public deposit can be repaid within three months from the date of acceptance. And if, a deposit is repaid prematurely, interest on that has to be reduced as per the norms prevailing at that time.
HFC can grant loan against public deposit accepted by it. Such loan amount should not exceed 75% of the deposit and interest rate charged should be at least 2% above the interest payable on the deposit.

SPECIAL PROVISIONS:
NHB has also provided some special provisions for HFCs. Lets discuss these provisions.

Maintenance of Minimum Liquid Assets: Every HFC should is required to invest in India in approved securities at market price, not less than 6 percent and up to 25 percent of the public deposits outstanding at the close of business on the last working day of the second preceding quarter. HFCs are required to maintain in India in an account with a bank or NHB or by subscription to bonds issued by NHB, a sum not less than 12.5% of public deposits, together with investment in approved securities. The HFC should entrust to one of the banks designated by it on that behalf, in the place where its registered office is situated, the approved securities required to be maintained by it.

Reserve Funds: Every HFC should create a reserve fund and transfer therein at least 20% of its net profit every year, before any dividend is declared. Any special reserve created by HFC in terms of Section 36(I)(viii) of the Income Tax Act, may take into account any sum transferred by it for the year to such special reserve for the purpose of this reserve.

Employee Security Deposit: A housing finance company receiving any amount in ordinary course of its business as security deposit from any of its employees for due performance of his / her duties, should keep it in a joint account with the employee in a bank or in a post office.

MISCELLANEOUS PROVISIONS

These provisions relate to submission of balance sheet, Directors' report, Auditor's Certificate, returns to NHB by HFCs and advertisement.

A. The HFCs are required to deliver to the NHB an audited balance sheet as on the last date of each financial year and audited profit and loss account in respect of that year as passed it in general meeting together with a copy of the report of the BOD within 15 days of such meeting as also a copy of the report and the notes on accounts furnished by its auditors.
B. The HFC should also furnish to the NHB a copy of the Auditor's report to the BOD and a certificate from its Auditors, being members of the ICAI in the prescribed format containing all necessary information.
C. Every HFC should submit to the NHB a return furnishing the specified information with reference to its position as on the specified date. Also, every HFC should, within one month from the commencement of business, deliver to the NHB a written statement containing list of names and designation of its principal officers, their complete postal address and contact information, specimen signatures etc.
D. Every HFC accepting public deposits is required to comply with the provisions of the NBFC and Miscellaneous NBC (Advertisement) Rules, 1977.

PRUDENTIAL NORMS:

The NHB guidelines to HFCs on prudential norms for income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/ investments are discussed hereunder.

Income Recognition: For the policy on income recognition to be objective it should be based on recognized accounting principles. Income from NPAs should be considered to have accrued and be recognized only when it is actually received. Interest on NPA should not be booked as income if such interest has remained outstanding for more than six months.

Accounting Standard: All accounting standards and guidelines notes issued by the ICAI dealing with lease accounting/ depreciation/ income recognition and so on may be followed by an HFC.

Accounting for Investment: All investments in securities should be bifurcated into current investments and long-term investments. A current investment is an investment that is by its nature readily realizable and is intended to be held for not more than one

year from the date on which such investment is made. A long-term investment is an investment other than a current investment.
Quoted current investments should be valued at cost or market value whichever is lower. Unquoted current investments should be valued at cost or breakup value whichever is lower. Long term investments should be valued in accordance with the accounting standards issued by ICAI.

ASSET CLASSIFICATION:
The HFCs should classify their loans and advances and any other form of credit into four broad groups: (a) standard assets (b) sub-standard assets (c) doubtful assets and (iv) loss assets. Following definitions can be used for classifying assets:

Standard Assets: A standard asset is one in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problems nor carry more than normal risk attached to business. Such an asset in not an NPA.

Substandard Asset: A standard asset is one which has been classified as NPA for a period not exceeding two years. Such an asset would have well-defined credit weakness that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the HFC would sustain some loss, if deficiencies are not corrected.

Doubtful Assets: A doubtful asset is one which has remained NPA for a period exceeding two years. Term loans, where installments of principals have remained overdue for a period exceeding two years, should be treated as doubtful asset. A loan classified as doubtful has all the weaknesses inherent in that classified as sub-standard with the added characteristics that the weakness may make collection/liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss Assets: A loss assets is one where loss has been identified by an HFC on internal/ external auditors/ the NHB inspection but the amount has not been written off, wholly or partly. Such an asset is considered un-collectable although there may be some salvage or recovery value.

PROVISIONING:
The HFCs are required to provide for loans and advances assets as follows:
Loans, Advances and other Credit Facilities including Bills purchased and discounted: Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realization of the security and erosion over time in the value of security charged, the HFC should make provisions against sub-standard, doubtful and loss assets in respect of loans advances and other credit facilities including bills purchased and discounted as under:
Loss Asset: The entire asset should be written off. If they are permitted to remain in the books for any reason, 100% of the outstanding balance should be provided for.

Doubtful Asset: 100% provision to the extent amount is deemed to be unrecoverable. For others, 20-50% of the secured portion depending upon the period for which the asset is considered to be doubtful.
Sub-standard Asset: A general provision of 10% of the total outstanding should be made.

CAPITAL ADEQUACY NORMS:
The HFCs should achieve a minimum capital adequacy norm of 10% of the risk weighted assets and off-balance sheet items by March, 2001 and 12 percent by March 31, 2002. The total of the Tier-II elements should be limited to a maximum of 100% of total of the Tier-I elements.
Reporting: The HFCs should furnish half-yearly return, in duplicate, indicating (a) capital funds and risk asset ratio (b) calculations of risk weighted assets and off-balance sheet exposures and (c) certain other data. The return should be signed by the Chief Executive of the company or in his absence, his authorized representative and be certified by the auditors of the company and submitted within a period of two months from the close of the half-year.
Concentration of Credit / Investment: The HFCs should not lend / invest more than 15 percent of their owned funds to any single party / in shares of another company and more than 25% to a single group of parties / in shares of single group of companies. They should not lend and invest (loans/investment taken together) more than 25% of owned fund to a single party and more than 40% to a single group of parties.
Loans against HFC's own shares prohibited: No HFC should lend against its own share, any kind of loans / advances or credit whatsoever.

REFINANCE SUPPORT TO HFC'S
The NHB has issued guidelines to HFCs who desire to avail of refinance facilities from the NHB for their growth on sound lines and to be healthy, viable and cost effective. The main elements of the guidelines for extending refinance support to HFCs are discussed hereunder.

Organisation and Main Activities: An HFC which desires to avail of refinance facility from the NHB should, inter alia (a) be a public limited company (b) provide long term finance for construction or purchase of houses in India for residential purposes and (c) invest 75% pf its 'capital employed' by way of long-term finance for housing.
Minimum Paid-up capital and listing requirements: The HFC should have a minimum-paid up capital or NOF of not less than Rs.10 Crores or such other amount as may be stipulated from time to time by the NHB and/or the SEBI for listing shares on recognized stock exchange(s). The promoter's contribution in their share capital would be as per the SEBI requirements from time to time.

Submission of Application: The HFCs should submit their application for refinance support in such form and furnish such information / statements and so on as may be required by the NHB for its considerations.
Name of the Company and Promoters: The HFC should also comply with following: They should not (a) bear a name resembling / similar / akin to the name of any construction company with which the promoters of the HFC may be associated, (b) be a subsidiary of a construction company, (c) have/ promote, as subsidiary, a

construction company, (d) indulge in construction activities of any kind, either directly or indirectly. The Chairman, MD or any whole-time director of any HFC should not hold the offices of Chairman, MD or whole time director in a construction company with which the promoters of the HFC may be associated or vice-versa.

Board of Directors: The AOA of the HFC should contain necessary provisions for appointment of nominee directors by the NHB. The appointment of CEO of HFCs, if deemed necessary, should be made in consultation with the NHB.
The HFC seeking refinance facility should comply with the Provisions of Housing Finance Companies (NHB) Directions, 1989. It should lend money only at the rates prescribed by NHB from time to time. The HFC must follow the Prudential norms and guidelines issued by the NHB.
The refinance facility is at sole discretion of the NHB and cannot be claimed as a matter of right. It would be also subject to refinance policy and exposure norms adopted by the NHB from time to time.

EQUITY SUPPORT TO HFCs:
For the growth of HFCs on sound lines and to be healthy, viable and cost effective, the NHB extends equity support to them. Now let us discuss the NHB guidelines in respect of equity support to HFCs.
Organization and main activity: The HFCs desirous of availing of equity participation from the NHB should, like the scheme for availing refinance, be a public company and fulfill other criterion like the refinance scheme.
Minimum Paid-up capital and listing requirement: The HFC should have a minimum paid up capital of Rs. 5 crores or such other amount as may be stipulated from time to time b the NHB and / or the SEBI for listing their shares on recognized stock exchanges. The promotees' contribution in share capital should be as per the SEBI requirement from time to time. They should get their shares listed on recognized stock exchange(s) in India as may be stipulated by NHB. They should conform and / or comply with all other rules, regulations, instructions, guidelines or orders issued by the NHB or any other authority empowered in that behalf. The NHB's participation in equity in any case would not exceed 10% of the paid up capital of an HFC or Rs. 1 crore, whichever is lower.

Other procedures/formalities like Submission of application, Name of the Company and Promoters, Board of Directors, are same as the formalities for refinance scheme.
Credit Rating: The HFC before approaching the NHB for equity support, should obtain credit assessment rating of themselves or equity grading by one of the four credit rating agencies namely – CRISIL, ICRA, CARE or DCR India. A minimum rating of CARE three or ICRA six or CRISIL six or equivalent rating or DCR India would be necessary for them to become eligible for equity support from the NHB.
Shareholder's Agreement: The HFCs should enter into a shareholder's agreement with the NHB laying down covenants regarding substantive issues like undertaking of new business, amalgamation, mergers, takeovers, flotation of subsidiaries, appointment of nominee directors and so on. The covenants would also include 'buy back' of shares and the method of valuation of shares which would be market value of shares at the stock exchange, or net asset value/ intrinsic value of shares or earning per share or cost of investment plus interest agreed rate, whichever be the highest.

Pricing of Shares / Cost of Investment: In the case of new HFCs without track record of profitability and dividend making, first public issue of equity shares would be subscribed by the NHB at par, and in the case of existing companies, price would be determined and approved by the BOD of the NHB.
The equity participation by the NHB would be at the sole discretion of NHB and not claimed as a matter of right.

Housing finance industry - an overview

Highlights

- Significantly, there has been no dearth of demand for housing and consequently for finances for the same have been abundant.
- Market dynamics play a pivotal role in determining the lending rates. Considering the same, the housing finance industry has been in a slump in recent times.
- The entry of banks into the housing finance sector has posed a serious threat to already existent players in the field.
- The housing sector is witnessing a clash between major players. Foremost amongst this is the ICICI and HDFC imbroglio. The later is giving sleepless nights to HDFC.
- Tax sops provided by the Government of India is a significant step towards upholding the future prospects of this industry.

Sector Comments

Nearly 25 lakh houses are built every year in India. However, the nation's requirement is around 65 lakh houses per annum. The housing sector in India is facing an estimated shortage of 4.1 crore houses and according to the Ninth Plan, the demand-supply gap in urban housing is 3.3 crore houses. In case, all these urban housing dwellings were to be built, it would require an investment of Rs. 150,370 crore.

Traditionally, the housing finance business has been yielding a margin of around 2 per cent. The skill of the players is in converting their advances that have a maturity period of 15-30 years with the deposits that mature within three years. Though, the National Housing Bank (NHB) refinances housing loan up to Rs. 2 lakh disbursed to the lower income group, this is just a negligible proportion of advances to the major players. The primary sources of funds are fixed deposits, debentures, private placement of bonds and borrowings from banks and financial institutions. Thus, efficient financial management has a key role to play in this industry.

Lending rates are predominantly market-driven and in view of the same, the housing finance industry has been in a slump in recent times with there being low demand from builders and investors alike. Furthermore, the entry of banks into the housing finance sector has also not augured well for the industry. Most housing finance companies cater mainly to the higher income group having reasonably assured creditworthiness. In a scenario marked with the absence of speedy foreclosure regulations, most companies prefer to stay away from rural and the Low-Income Group (LIG). However, it must be noted that demand for housing in the Middle-Income Group and High Income Group segments has also recorded a steady rise lately.

Market profile

The Indian housing finance sector is crowded with players of all sizes and nature: government organisations, insurance companies, banks, housing finance companies and co-operative organisations like HUDCO and NHB. Major players in the Industry are HDFC, LIC Housing Finance, Dewan Housing, Can Fin Homes, SBI Home Finance and Gujarat Rural Housing. The youngest entrant into the Industry, which is penetrating rapidly, is ICICI. Interestingly, both Can Fin Homes Limited and its parent Canara Bank are into housing finance. It is the same with quite a few banks, for example, SBI and SBI Home Finance Limited, Bank of Baroda and BOB Finance, Vysa Bank and Vysyabank Housing. Though HDFC and ICICI also have their banking arms, they compete with each other in personal loans, but not housing loans.
The industry comprises of nearly 383 housing finance companies although disbursements from only the leading 26 institutions are eligible for re-finance from National Housing Bank, which is the regulatory body for these companies. These Housing Finance Companies (HFCs) constitute nearly 95 % of the total disbursement by the industry. However, owing to the slump in real estate market over the last few years, the industry posted a fairly low disbursement growth.

Market trends
The housing sector is witnessing a clash between major players. HDFC had ruled this sector with a lion's stranglehold. It was smooth sailing for HDFC all these years and it seemed that its monopoly was there to stay forever. However, out of the blue emerged ICICI Home Loans, when this financial institution decided to clash arms with HDFC on its home front. Within a year of its launch, ICICI Home Loans is giving the industry leader, HDFC, sleepless nights.

Undercutting in the interest rates is all in the game and so is every other trick in the book. HDFC is gathering its wits to beat its competitor at its own game. It launched an aggressive hoarding campaign designed in the style of 'follow the leader'. HDFC has launched its website propertymartindia.com as a joint venture with the Mahindras. Following suit, ICICI too, launched its home portal www.indiahomeseek.com. So the war rages on both at the retail level and also in the form of a cyber war. ICICI has lowered its prime lending rates on short and medium term loans from 13 per cent to 12.5 per cent. Thus, bringing the interest on housing loans at par with the foreign exchange loans.

HDFC also reduced the interest rates on its housing loans from 13.25 per cent to 13 per cent. It went an extra mile to woo the borrowers of loans up to Rs. 1 crore by allowing them the facility to either opt for a fixed interest rate of 13 per cent or a floating interest rate of 12.5 per cent. As the name indicates, a borrower opting for the first choice will have to repay the loan at an interest rate of 13 per cent irrespective of any future hike or cut in the rates. Those choosing the second option would be subject to the vagaries of the interest market and may gain or lose in the bargain. The company has also reduced the interest on loans borrowed by non-resident Indians. These loans repayable within five years will attract an interest rate of 11.5 per cent per annum while loans with a term of 6-10 years will be charged interest at 12.5 per cent.
The above rates are under the fixed interest rate option. Similar floating rate loans would be charged at 5 per cent less interest. Originally, only the commercial banks

offered housing loans on floating interest rates, now that HDFC is offering loans at a 12 per cent floating rate, ICICI also has a floating rate home loan in the pipeline.

Price sensitivity factors

- Noteworthy fact here is that NHB refinance to the HFCs comprises a mere 7% of the loans disbursed. In other words, most HFCs have to arrange for a major part of the disbursals from their own resources. Thus, low spreads, mismatched asset and liability, competition posed by banks with recent regulations requiring commercial banks to invest 40 per cent of their advances towards the priority sector, etc. pose problems for the lending division.
- The first housing finance company to cut down its interest rate after RBI slashed the PPF interest rate by 1 per cent on January 14, 2000 was HUDCO. When the National Housing Bank, the refinancing agency of all housing finance companies, slashed its rates by up to 50 basis points, it triggered off a virtual interest war in the industry. HDFC, ICICI, LIC Housing Finance, PNB Housing Finance Limited and a host of others followed suit. In a game of one-upmanship, the companies have been vying with one another to offer the best deal in a rapidly growing market.
- CRISIL has forecast an increase in the interest rates in the second half of this year. This will be due to the demand of funds by the Centre and also the corporate exceeding the supply. The Central Government has projected a Rs. 31,000 crore higher borrowing this year than last year's figure of Rs. 86,000 crore. The State Government borrowings would add up to a further Rs. 27,500 crore and the corporate demand would be higher by Rs. 11,000 crore. As compared with the supply, CRISIL expects the short fall to be around Rs. 15,800 crore. To make up this short fall, even if there is a 1 per cent cut in CRR, interest rates are still bound to increase.
- The Union Budget 2000-01 has given a shot in the arm to the industry by raising the exemption applicable to individual borrowers on the interest paid on housing loans to Rs. 1 lakh. The existing tax rebate of 20 per cent under section 88 of the Income tax Act of 1961, covered repayment of housing loans, subject to a maximum of Rs. 10,000. The same has now been doubled to Rs. 20,000. This, coupled with the lowering of the interest rate would enable a borrower to enjoy tax exemption upto a loan of Rs. 7.5 lakh for a 15-year term. He can now have access to better tax planning options on account of the exemption and a lower Equated Monthly Instalment (EMI) due to longer term of repayment. Furthermore, individuals who already own a house can now invest in a new house and yet claim exemption from capital gains on the sale of the asset. The tax exemption on the interest paid on housing loans has also been extended up to the year 2003. This move will benefit the salaried employees, especially the middle-class populace. A dream of providing 25 lakh rural houses has been envisaged in the budget. Out of these, 12 lakh houses will be built under the 'India Awas Yojana' and another one-lakh houses would be provided under the 'Credit-cum-Subsidy' scheme for families with an annual income below Rs. 32,000. Moreover, around 1.5 lakh houses to be constructed under the 'Golden Jubilee Rural Housing Finance Scheme' will be eligible for refinance from the NHB.
- The industry has found new avenues such as securitisation, which are expected to be launched in the market very soon. This mechanism would

require a pool of assets (mortgages), which would be sold by the HFCs to NHB. These assets in turn would act as a Special Purpose Vehicle (SPV) and would be sold as pass through certificates to investors, which initially would be from groups earning pension funds, mutual funds, financial institutions, commercial banks and other trusts or institution which require monthly fixed income.

- The mortgages would be for loans up to a period of 10 years, on which HFCs would earn 16 % from borrowers. The spread is to be passed back to the concerned HFCs in the form of premium at purchase of mortgages or service charge over a period of time. It is expected that with the success of securitisation the circulation of funds would increase coupled with cash flows generated by these funds. Furthermore, a secondary market for mortgages would become feasible for HFCs.

Outlook

The industry is witnessing a boom at present boosted by the generous budget sops and rock bottom real estate prices. The demand is a result of genuine individual needs for housing. The prospects of the industry would be further strengthened on the amendments to the Rent Control Act and repealing of the controversial Urban Land Ceiling Act. Thus, the housing finance industry is on solid ground and has interesting prospects ahead. As for the small players, they will have to take the harsh decision to either exit the industry or merge with bigger entities. It is also amply clear that in the future, industry leader HDFC will have to share the spoils with the aggressive young turk - ICICI. Notwithstanding the competition, the customer has nothing to lose as he can choose the best loan scheme from the ICICI and HDFC fold, with minimum interest and a nil processing fee.

Conclusion

Despite the abovementioned factors, several bottlenecks still exist in the industry, which have to be taken care of before any of the above can bring about an improvement in the prospects of the industry. From an overall viewpoint demand for housing is ever rising and the same would be reflected on the demand for funds. Hence, the profitability of the industry should commence on the positive track in the future.

LESSON 17
TUTORIAL

LESSON OBJECTIVES: TO CLEAR ALL THE DOUBTS OF THE STUDENTS RELATED TO CONCEPTS COVERED IN VARIOUS TOPICS SO FAR COVERED.

Dear Students, so far we have had around one third of the total course of this particular subject. I hope you have been able to understand the concepts and their practical usage as an aspiring manager / entrepreneur.

Today's session is just to solve all your difficulties in topics so far covered. If you have any doubt or require any clarification on any topic, lets discuss that.

I also want you to collect newspaper clippings, web articles and articles from journals, for discussion and information sharing. The purpose of our study is not just to learn the theoretical concept, but also to understand their practical / actual usage in day to day life. Hence it is very important for you to collect such information and share / discuss it with your colleagues.

LESSON 18
VENTURE CAPITAL – THEORETICAL CONCEPT

Lesson Objectives: **To understand the Concept of Venture Capital, Types of venture capital funds, mode of operations and terminology of venture capital.**

INTRODUCTION

Venture Capital has emerged as a new financial method of financing during the 20th century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects.

There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long term finance made in:

1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures.

The term 'venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return. While the concept of venture capital is very old the recent liberalisation policy of the government appears to have given a fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In addition to providing capital, these VCFs (venture capital firms) take an active interest in guiding the assisted firms.

A young, high tech company that is in the early stage of financing and is not yet ready to make a public offer of securities may seek venture capital. Such a high risk capital is provided by venture capital funds in the form of long-term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Thus, a venture capitalist (VC) may provide the seed capital for unproven ideas, products, technology oriented or start up firms. The venture capitalists may also invest in a firm that is unable to raise finance through the conventional means.

FEATURES OF VENTURE CAPITAL

"Venture capital combines the qualities of a banker, stock market investor and entrepreneur in one."

The main features of venture capital can be summarised as follows:

(i) High Degrees of Risk Venture capital represents financial investment in a highly risky project with the objective of earning a high rate of return.

(ii) Equity Participation Venture capital financing. is, invariably, an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable. .

(iii) Long Term Investment Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.

(iv) Participation in Management In addition to providing capital, venture capital funds take an active interest in the management of the assisted firms. Thus, the approach of venture capital firms is different from that of a traditional lender or banker. It is also different from that of a ordinary stock market investor who merely trades in the shares of a company without participating in their management. It has been rightly said, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".

(v) Achieve Social Objectives It is different from the development capital provided by several central and state level government bodies in that the profit objective is the motive behind the financing. But venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.

(vi) Investment is liquid A venture capital is not subject to repayment on demand as with an overdraft or following a loan repayment schedule. The investment is realised only when the company is sold or achieves a stock market listing. It is lost when the company goes into liquidation.

ORIGIN

Venture capital is a post-war phenomenon in the business world mainly developed as a sideline activity of the rich in USA. The concept, thus, originated in USA in 1950s when the capital magnets like Rockfeller Group financed the new technology companies. The concept became popular during 1960's and 1970's when several private enterprises started financing highly risky and highly rewarding projects. To denote the risk and adventure and some element of investment, the generic term "Venture Capital" was developed. The American Research and Development was formed as the first venture organisation which financed over 100 companies and made profit over 35 times its investment. Since then venture capital has grown' vastly in USA, UK, Europe and Japan and has been an important contribution in the economic development of these countries.

Of late, a new class of professional investors called venture capitalists has emerged whose specialty is to combine risk capital with entrepreneurs management and to use advanced technology to launch new products and companies in the market place. Undoubtedly, it is the venture capitalist's extraordinary skill and ability to assess and manage enormous risks and extort from them tremendous returns that has attracted more entrants. Innovative, hi-tech ideas are necessarily risky. Venture

capital provides long-term start-up costs to high risk and return projects. Typically, these projects have high mortality rates and therefore are unattractive to risk averse bankers and private sector companies.

Venture capitalist finances innovation and ideas, which have potential for high growth but are unproven. This makes it a high risk, high return investment. In addition to finance, venture capitalists also provide value-added services and business and managerial support for realizing the venture's net potential.

TYPES OF VENTURE CAPITALISTS

Generally, there are three types of organized or institutional venture capital funds -

(i) Venture capital funds set up by angel investors, that is, high network individual investors

(ii) Venture capital subsidiaries of corporations - these are established by major corporations; commercial bank holding companies and other financial institutions

(iii) Private capital firms/funds-The primary institutional source of venture capital is a venture capital firm venture capitalists take high risks by investing in an early stage company with little or no history and they expect a higher return for their high-risk equity investments in the venture.

MODES OF FINANCE BY VENTURE CAPITALISTS

Venture capitalists provide funds for long-term in any of the following modes

(1) *Equity* - Most of the venture capital funds provide financial support to entrepreneurs in the form of equity by financing 49% of the total equity. This is to ensure that the ownership and overall control remains with the entrepreneur. Since there is a great uncertainty about the generation of cash inflows in the initial years, equity financing is the safest mode of financing. A debt instrument on the other hand requires periodical servicing of debt.

(2) *Conditional loan* - From a venture capitalist~ point of view, equity is an unsecured instrument and hence a less preferable option than a secured debt instrument. A conditional loan usually involves either no interest at all or a coupon payment at nominal rate. In addition, a royalty at agreed rates is payable to the lender on the sales turnover. As the units picks up in sales levels, the interest rate are increased and royalty amounts are decreased.

(3) *Convertible loans* - The convertible loan is subordinate to all other loans, which may be converted into equity if interest payments are not made within agreed time limit.

Areas of Investment

Different venture groups prefer different types of investments. Some specialize in seed capital and early expansion while others focus on exit financing. Biotechnology, medical services, communications, electronic components and software companies seem to be attracting the most attention from venture firms and receiving the most financing. Venture capital *firms* finance both early and later stage investments to maintain a balance between risk and profitability.

In India, software sector has been attracting a lot of venture finance. Besides media, health and pharmaceuticals, agri-business and retailing are the other areas that are favored by a lot of venture companies.

STAGES OF INVESTMENT FINANCING

"Venture capital *firms* finance both early and later stage investments to maintain a balance between risk and profitability." Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely:

A. Early Stage Financing

(i) Seed Capital & Research and Development Projects.

(ii) Start Ups

(ii) Second Round Finance

B. Later Stage Financing

(i) Development Capital

(ii) Expansion Finance

(iii) Replacement Capital

(iv) Turn Arounds

(v) Buy Outs

A. Early Stage Financing This stage includes the following:

I. *Seed Capital and R & D Projects:* Venture capitalists are more often interested in providing seed finance *i. e.* making provision of very small amounts for finance needed to turn into a business.

Research and development activities are required to be undertaken before a product is to be launched. External finance is often required by the entrepreneur during the development of the product. The financial risk increases progressively as the research phase moves into the development phase, where a sample of the product is tested before it is finally commercialised "venture capitalists/firms/ funds are always ready to undertake risks and make investments in such R & D projects promising higher returns in future.

II. *Start Ups:* The most risky aspect of venture capital is the launch of a new business after the Research and development activities are over. At this stage, the entrepreneur and his products or services are as yet untried. The finance required usually falls short of his own resources. Start-ups may include new industries / businesses set up by the experienced persons in the area in which they have knowledge. Others may result from the research bodies or large corporations, where a venture capitalist joins with an industrially experienced or corporate partner. Still other start-ups occur when a new company with inadequate financial resources to commercialise new technology is promoted by an existing company.

III. *Second Round Financing:* It refers to the stage when product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture Capital Institutions (VCIs) provide larger funds at this stage than at other early stage financing in the form of debt. The time scale of investment is usually three to seven years.

B. Later Stage Financing

Those established businesses which require additional financial support but cannot raise capital through public issue approach venture capital funds for financing expansion, buyouts and turnarounds or for development capital.

I. *Development Capital:* It refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support. Funds are needed for the purchase of new equipment/plant, expansion of marketing and distributing facilities, launching of product into new regions and so on. The time scale of investment is usually one to three years and falls in medium risk category.

II. *Expansion Finance:* Venture capitalists perceive low risk in ventures requiring finance for expansion purposes either by growth implying bigger factory, large warehouse, new factories, new products or new markets or through purchase of exiting businesses. The time frame of investment is usually from one to three years. It represents the last round of financing before a planned exit.

III. *Buy Outs:* It refers to the transfer of management control by creating a separate business by separating it from their existing owners. It may be of two types.

   (i) Management Buyouts (MBOs): In Management Buyouts (MBOs) venture capital institutions provide funds to enable the current operating management/ investors to acquire an existing product line/business. They represent an important part of the activity of VCIs.

   (ii) Management Buyins (MBIs): Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company. It involves three parties: a management team, a target company and an investor (i.e. Venture capital institution). MBIs are more risky than MBOs and hence are less popular because it is difficult for new management to assess the actual potential of the target company. Usually, MBIs are able to target the weaker or under-performing companies.

IV. Replacement Capital-V CIs another aspect of financing is to provide funds for the purchase of existing shares of owners. This may be due to a variety of reasons including personal need of finance, conflict in the family, or need for association of a well known name. *The* time scale of investment is one to three years and involve low risk.

V. Turnarounds-Such form of venture capital financing involves medium to high risk and a time scale of three to five years. It involves buying the control of a sick company which requires very specialised skills. It may require rescheduling of all the company's borrowings, change in management or even a change in ownership. A very active "hands on" approach is required in the initial crisis period where the venture capitalists may appoint its own chairman or nominate its directors on the board.

In nutshell, venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability. Venture capitalists evaluate technology and study potential markets besides considering the capability of the promoter to implement the project while undertaking early stage investments. In later stage investments, new markets and track record *of* the business/entrepreneur is closely examined.

FACTORS AFFECTING INVESTMENT DECISIONS:

The venture capitalists usually take into account the following factors while making investments:

(1) Strong Management Team. Venture capital firms ascertain the strength *of* the management team in terms *of* adequacy of level of skills,., commitment and motivation that creates a balance between members in area such as marketing, finance and operations, research and development, general management, personal management and legal and tax issues. Track record *of* promoters is also taken into account.

(2) A Viable Idea. Before taking investment decision, venture capital firms consider the viability *of* project *or* the idea. Because a viable idea establishes the market for the product or service. Why the customers will purchase the product, who the ultimate users are, who the competition is with and the projected growth of the industry?

(3) Business Plan. The business plan should concisely describe the nature *of* the business, the qualifications *of* the members of the management team, how well; the business has performed, and business projections and forecasts. The promoters experience in the proposed *or* related businesses is an important consideration. The business plan should also meet the investment objective of the venture capitalist.

(4) Project Cost and Returns A. VCI would like to undertake investment in a venture only if future cash inflows are likely to be more than the present cash outflows. While calculating the Internal Rate *of* Return (IRR) the risk associated with the business proposal, the length of time his money will be tied up are taken into consideration. Project cost, scheme of financing, sources of finance, cash inflows for next five years are closely studied.

(5) Future Market Prospects. The marketing policies adopted, marketing strategies in relation to the competitors, market research undertaken, market size, share and future market prospects are some of the considerations that affect the decision.

(6) Existing Technology. Existing technology used and any technical collaboration agreements entered into by the promoters also to a large extent affect the investment decision.

(7) Miscellaneous Factors. Others factors which indirectly affect the investment decisions include availability of raw material and labor, pollution control measures undertaken, government policies, rules and regulations applicable to the business/industry, location of the industry etc.

SELECTION OF VENTURE CAPITALISTS

Venture capital industry has shown tremendous growth during the last ten years. Thus, it becomes necessary for the entrepreneurs to be careful while selecting the venture capitalists. Following factors must be taken into consideration:

(1) *Approach adopted by VCs* - Selection of VCs to a large extent depends upon the approach adopted by VCs.

   (a) Hands on approach of VCs aims at providing value added services in an advisory role or active involvement in marketing, recruitment and funding technical collaborators. VCs show keen interest in the

management affairs and actively interact with the entrepreneurs on various issues.

(b) Hands off approach refers to passive participation by the venture capitalists in management affairs. VCs just receive. periodic financial statements. VCs enjoy the right to appoint a director but this right is seldom exercised by them.

In between the above two approaches lies an approach where V C' s approach is passive except in major decisions like change in top management, large expansion or major acquisition.

(2) *Flexibility in deals* - The entrepreneurs would like to strike a deal with such venture capitalists who are flexible and generous in their approach. They provide them a package which best meet the needs of the entrepreneurs. VC's having rigid attitude may not be preferred.

(3) *Exit policy* - The entrepreneurs should ask clearly the venture capitalists as to their exit policies whether it is buy back or quotation or trade sale. To avoid conflicts, clarifications should be sought in the beginning; the policy should not be against the interests of the business. Depending upon the exit policy of the VCs, selection would be made by the entrepreneurs.

(4) *Fund viability and liquidity* - The entrepreneurs must make sure that the VCs has adequate liquid resources and can provide later stage financing if the need arises, also, the VC has committed backers and is not just interested in making quick financial gains.

(5) *Track record of the VC & its team* - The scrutiny of the past performance, time since operational, list of successful projects financed earlier etc. should be made by the entrepreneur. The team of VCs, their experience, commitment, guidance during bad times are the .other consideration affecting the selection of VCs.

PROCEDURE FOLLOWED BY VCs

(a) Receipt of proposal. A proposal is received by the venture capitalists in the form of a business plan. A detailed and well-organised business plan helps the entrepreneur in gaining the attention of the VCs and in obtaining funds. A well-prepared business proposal serves two functions.

(1) It informs the venture capitalists about the entiepreneurs ideas.

(2) It shows that the entrepreneur has detailed knowledge about the proposed business and is aware of the all potential problems.

(b) Appraisal of plan. VC appraises the business plan giving due regard to the creditworthiness of the promoters, the nature of the product or service to be developed, the markets to be served and financing required. VCs also conduct cost-benefit analysis by comparing future expected cash inflows with present investment.

(c) Investment. If venture capital fund is satisfied with the future profitability of the company, it will take step to invest his own money in the equity shares of the new company known as the assisted company.

(d) Provide value added services. Venture capitalists not only invest money but also provide managerial and marketing assistance and operational advice. They also make efforts to accomplish the set targets which consequently results in appreciation of their capital.

(e) Exit. After some years, when the assisted company has reached a certain stage of profitability the VC sells his shares in the stock market at high premium, thus earning profits as well as releasing locked up funds for redeployment in some other venture and this cycle continues.

LESSON 19
VENTURE CAPITAL – NATIONAL AND INTERNATIONAL SCENARIO

Lesson Objectives: **To get an understanding of national and international scenario of venture capital financing.**

Governments efforts in the venture capital area.

VENTURE CAPITAL IN INDIA

Venture capital was almost absent till 1975 when Industrial Finance Corporation of India (IFCI) set up Risk Capital Foundation (RCF). This was considered as the first step in the direction of venture capital.

In the year 1976, initiative had been taken by the Government of India to create Technical Development Fund (TDF) in the Ministry of Industry with the assistance of World Bank. The main intention was to ensure sufficient rupee resources to finance the modernisation programs.

In the year 1986, Government of India announced the setting up of venture capital fund (VCF) to encourage the enterprise based on indigenous technology and upgradation of existing technology.

Grindlays Bank of Australia set up Indian Technology Fund Ltd. (ITFL) with the objective of providing venture capital assistance to young and growing companies seeking funds at early stages.

State Bank of India and Canara Bank have entered in the business of venture capital. SBI Capital Markets (SBI Caps), a subsidiary of SBI's merchant banking has set up a venture capital fund for "brought out deals". Under this scheme SBI Caps invests ip. the equity- shares of new companies.

The Industrial Credit and Investment Corporation of India (ICICI) also entered in the field of venture capital by establishing a venture capital fund for assisting small and medium entrepreneurs with initial equity capital. This was provided for developing and commercialising the indigenous technology.

India has taken a unique step in introducing venture capital in the area of bio-technology. The Bangalore based Bangalore Genei Pvt. Ltd. will be India's first ever venture capital bio-technology company engaged in the manufacture of enzymes used in genetic engineering manipulations in research and technology.

A significant feature of venture capital financing in India, which is little recognised, is the support the commercial banks provide to small scale industries. The small scale industries in India run both the risks inherent in a venture capital project-the failure of management and the high risks in the venture.

The venture capital providers in India (other than the commercial banks' efforts as stated above) can be divided into following categories.

(1) Specialised financial institutions and their financing schemes.
(2) Funds promoted by state level institutions.
(3) Funds promoted by public sector banks.
(4) Private agencies.
(5) Overseas venture capital funds

I. **SPECIAL/SED FINANCIAL INSTITUTIONS AND THEIR FINANCING SCHEMES**

In India, the Industrial Financial Corporations of India (IFCI), Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI) are the major three institutions, which are engaged in the financing of high tech new ventures. The difference and similarities between three schemes of IFCI, IDBI and ICICI are discernible from the objectives sought to be pursued under the broad characteristics of the schemes precisely explained below.

A. Risk Capital Scheme of IFCI

The IFCI began its equity financing through its Risk Capital Foundation (RCF) by providing risk capital assistance on soft terms to first generation entrepreneurs. The corporation envisages to provide assistance to technologists and the professionals who do not have adequate resources of their own for contributing to equity capital of the industrial projects undertaken by them with a view to enlarging entrepreneurial base for wider dispersal of ownership and control of industry in the national interest. The corporation is continuing its efforts through the newly formed Risk Capital and Technology Finance Corporation Ltd. (RCTFC) set up in 1988 as a wholly owned subsidiary of the IFCI. RCTFC was established with an objective of providing financial support to such activities in the area of innovative technology, energy conservation and environmental pollution. Some of the projects financed under the new scheme of IFCI include development of artificial intelligence software, three Dimensional Computer animation, educational robots, hybrid seeds etc.

In addition to operating its own schemes, the RCTC also manages a Venture Capital Unit Scheme VECAUS-III (started in mid-1991) with a resource base of Rs. 30 crores with participation from the UTI, IFCI and World Bank in equal proportions.

B. Technology Development & Information Company of India Ltd. (TDICI) of ICICI

Encouraged by the response to technology financing, ICICI floated a separate company-Technology Development and Information Company of India (TDICI) in collaboration with UTI in 1988. Apart from Venture Capital financing TDICI activity profile includes technology consultancy services and technology escort services such as marketing, business management, export marketing and guidance for individual venture capital projects etc. TDICI makes investments in highly risky projects promising high return in future. It gives preference to companies, which are unable to raise public share capital and would not be financed by anyone else.

In addition to equity participation (upto a maximum of 49%) undertaken by typical venture capital companies, TDICI offers the unique option of conditional loans. The entrepreneur neither pays interest on it nor does he have to repay the principal amount. If the venture succeeds, TDICI recovers back its investment in the form of royalty on sales which ranges between 2 % to 8 % . On the contrary, if venture fails to take off even after 5 years, TDICI will consider writing off the loan.

TDICI usually has a nominee on the Boards of companies with whom it enters into long-term contracts. TDICI assists such venture projects in arranging working capital finance, recruiting senior executives. It als.o takes advise of the outside experts in taking various decisions. Some of the projects financed by ICICI includes:

(i) Mastek a Bombay based software firm in which TDICI invested Rs. 42 lakh in equity in 1989 went public in 1992. It showed an annual growth of 70% to 80% in the turnover.

(ii) Temptation Foods which exports frozen vegetables and fruits, went public in November, 1992. The TOICI invested Rs. 50 lakhs in its equity .

C. SEED Capital Scheme or Venture Capital Fund of IDBI

IDBI's scheme is known as "Seed Capital Scheme" intended to help create a new generation of entrepreneurs who have the requisite traits of entrepreneurship but who lack financial resources to promote industrial ventures. The assistance is provided for meeting the risk capital requirements of entrepreneurs.

IDBI is doing well under the venture capital fund scheme by assisting the projects which are engaged in the promotion and development of indigenous technology, that is new and untested in India. The financial assistance is provided under this scheme in the areas of chemical, software electronics, bio-technology, food products and medical equipment.

The project cost varies between Rs. 5 lakh to Rs. 250 lakh. IDBI provides assistance both *for* financing the cost *of* fixed assets as well as *for* meeting the operating expenses in the *form of* unsecured loans carrying a concessional interest rate *of* 6% p.a. during the early stages *of* development.

II. FUNDS PROMOTED BY STATE LEVEL INSTITUTIONS

Funds promoted by state level institutions include:

(a) APIDC- Venture Capital Ltd. (A VCL)

This is wholly owned by the Andhra Pradesh Industrial Development Corporation Ltd. It aims at specialising venture fund management company. It has been entrusted with the management of a fund, namely APIDC - Venture Capital Fund. It is established with a capital *of* 13.5 crores contributed by APIDC, IDBI, Andhra Bank and IOB and *few* small organisations. The A VCL undertakes investments with the objective *of* bringing technological innovations in order to improve quality, reduce energy consumption, increase competition and enhanced exports.

(b) Gujarat Venture Finance Ltd. (GVFL)

The GVFL has been promoted by Gujarat Industries Investment Corporation Ltd., (GIIC) in association with Gujarat Lease Finance Corporation Ltd., Gujarat Alkalies and Chemicals Ltd. and Gujarat State Fertiliser Corporation Ltd. GIIC holds 40% *of* the equity capital *of* the GVFL and the rest is contributed by other three organisations. The GVFL is a fund management company, and presently acts as a trustee manager *of* a venture fund, namely (GVCF) Gujarat Venture Capital Fund, started in 1990. GVFL provides finance for innovations in technology leading to an improvement - in product quality and energy conservation, for launching new products based on imported technology.

III. FUNDS PROMOTED BY PUBLIC SECTOR BANKS SUCH AS *CANARA BANK VENTURE CAPITAL FUND (CVCF)*

This fund has been promoted by Canara Bank and its subsidiary Canbank Financial Services Ltd. (CANFINA). It was set up in 1989 as a trust. It provides finance in the form *of* equity, conditional loans, conventional loans or both. Its capital

base is Rs. 24 crores. The Fund aims at providing financial support for commercial exploitation *of* new technologies, technology up-gradation to improve quality etc.

IV. PRIVATE AGENCIES

Venture capital funds set up in the private sector include

(1) Credit Capital Venture Fund (CCVF)
(2) 20th Century Venture Capital Fund
(3) India Investment Fund
(4) Indus Venture Capital Fund (IVCF) (5) SBI Capital Venture Capital Fund

(1) *Credit Capital Venture Fund (CCVF)* - The Credit Capital Venture Fund (India) was established in 1986. It has a capital base of 10.8 crores. The principal shareholders are Credit Capital Finance Corporation, Bank of India, Asian Development Bank, Common Wealth Development Corporation. It finances ventures promising high returns with maximum assistance limited to Rs. 50 lakhs. It also provides value added services in an advisory role and actively participates in marketing, recruitment and management affairs. -Thus it helps the entrepreneurs to realise maximum returns. It has recently launched 10 state funds of Rs. 10 crore each. It is now known as Lazard Credit Capital Fund (India) Ltd. (LCCVF).

(2) *20th Century Venture Capital Fund* It was promoted by 20th Century Finance Ltd. and has a resource base of Rs. 20 crores. The fund aims at reviving the sick industries and help first generation entrepreneurs.

(3) *India Investment Fund* It is India's first private venture capital fund mainly subscribed by Non-Resident Indians (NRIs). The Fund is "an offshore company owned predominantly by NRI investors incorporated in early 1987. The fund provides equity or equity linked finance to new projects or often young as well as established Indian companies which can demonstrate a potential for sustained growth. The maximum assistance made available to one venture is limited to Rs. one crore. The principal investment objectives of the fund is long term capital appreciation. "

Merchant Banking Division of Grindlays Bank has been retained as the advisers for the Fund which evaluates and recommends specific investment proposals. The fund follows hands off approach in making the investment.

(4) *Indus Venture Capital Fund (lVCF)* This fund was promoted by Shri T. Thomas, the former Director of Unilever. The Indus Venture Management Ltd. (IVML) has been entrusted with the management of (IVCF). IVCF has a capital resource of Rs. 21 crores contributed by IVML, the IDB!, IFCI, Deutsche Bank, International Finance Corporation (Washington) and a few other national/international organisations.

(5) *SBI Capital Venture Capital Fund*. This fund has been set up by the SBI Capital Markets Ltd. to finance ventures through its "bought out deals". The objective behind the fund is to promote new capital issues by purchasing them when capital market is sluggish and disposing them off at times when market picks-up. The fund has a capital base of Rs. 10 crore.

V. *OVERSEAS VENTURE CAPITAL FUNDS*

Overseas Venture Capital Funds look for investment in areas ensuring high and guaranteed returns such as tourism, hospitals, air transport, information technology, communication, pharmaceutical, consumer durables, food processing industry, machinery components and textiles etc. Following are some of the examples where foreign venture capitalists have undertaken investments:

(1) The global insurance giant, AIG, has tied up with IL & SF to float a 150 million venture fund.

(2) The IL & SF is also planning to launch a $ 100 million fund with the ADB.
(3) George,Sors has already floated the Indocean Fund.
(4) NIKKO Securities has tied up with Walden and San Francis Company to float a venture capital fund with a minimum capital of $ 50 million.

DIFFICULTIES IN INDIA

(1) The restrictive legal and financial framework is one of the main reason for - die lack of development of venture capital industry in India.
(2) Fundamentally, there are no private pools of capital of finance risk ventures in India. The financial institutions occupy a dominant position in providing long term finance to Indian industry. FIs and the state development agencies do provide limited amounts of equity finance to assist in the development of new business but there are no private, professionally managed investment capital sources.
(3) There are no private sector insurance companies or pension funds gathering regular premium income and virtually no private banks willing to devote a small portion of their resources to the venture capital projects.
(4) Small companies have no access to share capital or long term debenture capital. The absence of a proper system of financing such companies has been a major gap in the Indian capital market. .
(5) While the government institutions no doubt meet part of venture capital requirements, tl1eir procedural delays and bottlenecks, the rigidity of the government's announced parameters for priority lending and strict standards about security and collaterals and the like often create problems for new entrepreneurs wishing to set up enterprises in high technology areas.
(6) Venture capital financing involves funding of relatively new projects with no proven record in market acceptability. This does not make the venture capital financing an attractive investment. There are other more attractive options available to an investor.
(7) The venture capitalists have not been given tax incentives commensurate with the risks they carry. This has also been responsible for the slow growth of venture capital industry.

NEED FOR GROWTH

India possesses a pool of young educated and technically qualified 'entrepreneurs with real innovative mind. Vast potentials of our country need to be properly tapped for continuous development, broadening of the industrial base of high-tech industries and to promote the growth of technology. Venture capital would provide the required initial funding facilities for the advancement of untried and untested technology. This new financing scheme would remove the constraints like inadequate funds, lack of encouragement to our young entrepreneurs etc. The changing economic scenario and the liberalisation of capital market would bring greater depth to the capital market as a whole, introducing more genuine investors of substance with long time horizons, provide avenues for the institutions to realise their equity portfolios more easily (freeing funds for more new investment) and generally improve market liquidity. This would improve equity cult.

SEBI (VENTURE CAPITAL FUND) REGULATIONS, 1996

The existing set up of venture capital in India needs to be streamlined and strengthened. The entry of private sector should be encouraged. Tax exemptions and concessions should be given to the investors investing in risky ventures. Government should offer attractive opportunities to foreign investors to invest in venture capital firms.

SEBI has been a regulatory body for venture capital companies or funds with effect from Jan. 25, 1995. It issued certain guidelines on 4th December, 1996 which defines venture capital fund as "fund established in the form of a company or trust which raises moneys through loans, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations". The Guidelines are listed below:

I. Registration of venture capital funds

Application for grant of certificate:

(1) Any company or trust proposing to carry on any activity as a venture capital fund on or after the commencement of these regulations shall make an application to the Board for grant of a certificate.

(2) Any company or trust, who on the date of commencement of these regulations is carrying any activity as a venture capital fund without a certificate shall make an application to the Board for grant of a certificate within a period of three months from the date of such commencement: Provided that the board, in special cases, may extent the said period up to a maximum of six months form the date of such commencement.

(3) An application for grant of certificate under sub-regulation (1) or sub-regulation (2) shall be made to the Board in Form A and shall be accompanied by a non-refundable application fee of Rs. 25,000 by way of bank draft issued in favor of SEBI at Mumbai.

(4) Any company or trust referred to in sub-regulation (2) who fails to make an application for grant of a certificate within the period specified therein shall cease to carry on any activity as a venture capital fund.

(5) The Board may in the interest of the investors issue directions with regard to the transfer of records, documents or securities or disposal of investments relating to its activities as a venture capital fund.

(6) The Board may in order to protect the interests of investors appoints any person to take charge of records, documents, securities and for this purpose also determine the terms and conditions of such an appointment.

Eligibility criteria. For the purpose of the grant of a certificate by the Board the applicant have to fulfil in particular the following conditions, namely

(a) If the application is made by a company

(i) memorandum of association as has its main objective, the carrying on of the activity of a venture capital fund;

(ii) it is prohibited by its memorandum and articles of association from making an invitation to the public to subscribe to its securities;

(iii) its director or principal officer or employee is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant;

(iv) its director, principal officer or employee has not at any time been convicted *of* any offence involving moral turpitude or any economic offence;

(v) it is a fit and proper person;

(b) if the application is made by a trust

(i) the instrument of trust is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908) ;

(ii) the main object of the trust is to carry on the activity of a venture capital fund;

(iii) the directors of its trustee company, if any or any trustee is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant;

(iv) the directors of its trustee company, if any, or a trustee has not at any time, been convicted of any offence involving moral turpitude or of any economic offence;

(v) the applicant is a fit and proper person;

(c) the company or trust has not been refused a certificate by the Board or its certificate has been suspended or cancelled.

Furnishing of information, clarification: The Board may require the applicant to furnish such further information as it may consider necessary.

Consideration of application: An application which is not complete in all respects shall be rejected by the Board: Provided that, before rejecting any such application, the applicant shall be given an opportunity to remove, within thirty days of the date of receipt of communication, the objections indicated by the Board: Provided further that the Board may, on being satisfied that it is necessary to extend the period specified in the first proviso, extend such period by such further time not exceeding ninety days.

Procedure for grant of certificate

(1) If the Board is satisfied that the applicant is eligible for the grant of certificate, it shall send an intimation to the applicant.

(2) On receipt of intimation, the applicant shall pay to the Board, the registration fee of Rs. 500,000 payable by way of bank draft in favor of SEBI at Mumbai.

(3) The Board shall on receipt of the registration fee grant a certificate of registration in Form B.

Conditions of certificate: The certificate granted shall be *inter alia,* subject to the following conditions, namely-'

(a) the venture capital fund shall abide by the provisions of the Act, the Government of India Guidelines and 1hese regulations;

(b) the venture capital fund shall not carry on any other activity other than that of a venture capital fund;

(c) the venture capital fund shall forthwith inform the Board in writing if any information or particulars previously submitted to the Board are found to be false or misleading in any material particular or if there is any change in the information already submitted.

Procedure where certificate is not granted

(1) After considering an application if the Board is of the opinion that a certificate should not be granted, it may reject the application after giving the applicant a reasonable opportunity of being heard.

(2) The decision of the Board to reject the application shall be communicated to the applicant within thirty days.

Effect of refusal to grant certificate

1. Any applicant whose application has been rejected shall not carryon any activity as a venture capital fund.
2. Any company or trust whose application for grant of certificate has been rejected by the Board shall, on and from the date of the receipt of the communication cease to carry on any activity as a venture capital fund.
3. The Board may in the interest of the investors issue directions with regard to the transfer of records, documents or securities or disposal of investments relating to its activities as a venture capital fund.
4. The Board may in order to protect the interests of the investors appoint any person to take charge of records, documents, securities and for this purpose also determine the terms and conditions of such an appointment.

II Investment conditions and restrictions

Minimum investment in a venture capital fund

(1) A venture capital fund may raise monies from any investor whether Indian, foreign or non-resident Indian.

(2) No venture capital fund set up as a company or any scheme of a venture capital fund set up as a trust shall accept any investment from any investor which is less than five lakh rupees: Provided that nothing contained in sub-regulation (2) shall apply to investors who are *(a)* employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust; or *(b)* non-resident Indians; or *(c)* persons or institutions of foreign origin.

Restrictions on investment by a venture capital fund. All investments made or to be made by a venture capital fund shall be subject to the following restrictions:

(a) the venture capital fund shall not invest in the equity shares of the company or institutions providing financial services;

(b) at least 80 per cent of funds raised by a venture capital fund shall be invested in

(i) the equity shares or equity related securities issued by a company whose securities are not listed on any recognised stock exchange: Provided that a venture capital fund may invest in equity shares or equity related securities of a company whose securities are to be listed or are listed where the venture capital fund has made. these investments through private placements prior to the listing of the securities;

(ii) the equity shares or equity related securities of a financially weak company or a sick industrial company, whose securities mayor may not be listed on any recognised stock exchange.

Explanation-For the purposes of this regulation, a "financially weak company" means a company, which has at the end of the previous financial year accumulated losses,

which has resulted in erosion of more than 50 % but less than 100 % of its networth as at the beginning of the previous financial year;

(iii) providing financial assistance in any other manner to companies in whose equity shares the venture capital fund has invested under sub-clause *(i)* or sub-clause *(iO,* as the case may be.

Explanation-For the purposes of this regulation, "funds raised" means the actual monies raised from investors for subscribing to the securities of the venture capital fund and includes monies raised from the author of the trust in case the venture capital fund has been established as a trust but shall not include the paid up capital of the trustee company, if any.

Prohibition on listing - No venture capital fund shall be entitled to get its securities or units, as the case may be, listed on any recognised stock exchange till the expiry of three years from the date of the issuance of securities or units, as the case may be, by the venture capital fund.

III. General obligations and responsibilities

Prohibition on inviting subscription from the public No venture capital fund shall issue any document or advertisement inviting offers from the public for the subscription or purchase of any of its securities or units.

Private placement A venture capital fund may receive monies for investment in the venture capital fund through private placement of its securities or units.

Placement memorandum

(I) The venture capital fund established as a trust shall, before issuing any units, file witl1 the Board a placement memorandum which shall give details of the terms subject to which monies are proposed to be raised from investors.

(2) A venture capital fund established as a company shall, before making an offer inviting any subscription to its securities, file with the Board a placement memorandum which shall give details of the terms subject to which monies are proposed to be raised from the investors.

Contents of placement memorandum

(1) The placement memorandum referred to in sub-regulation (1) of regulation shall contain the following, namely:

(a) details of the trustees or trustee company of the venture capital fund; .
(b) details of entitlement on the units of the trust for which subscription is being sought;
(c) details of investments that are proposed to be made;
(d) tax implications that are likely to apply to investors;
(e) manner of subscription to the units of the trust;
(f) the period of maturity, if any, of the scheme;
(g) the manner, if any, in which the scheme is to be wound up;
(h) manner in which the benefits accruing to investors in the units of the trust are to be distributed;
(i) details of the asset management company, if any, and of fees to be paid to such a company.

(2) The placement memorandum referred to in sub-regulation (2) above shall contain the following namely:

(a) details of the securities that are being offered;
(b) details of investments that are proposed to be made;
(c) details of directors of the company;

(d) tax implications that are likely to apply to investors;
(e) manner of subscription to the securities that are to be issued;
(f) manner in which the benefits accruing to investors in the securities are to be distributed; and
(g) details of the asset management company, if any, and of fees to be paid to such a company.

Circulation of placement memorandum. The placement memorandum may be issued for private circulation only after the expiry of twenty-one days of its submission to the Board: provided that if, within twenty-one days of submission of the placement memorandum, the Board communicates any amendments to the placement memorandum, the venture capital fund shall carry out such amendments in the placement memorandum before such memorandum is circulated to the investors.

Changes in the placement memorandum to be intimated to the Board Amendments or changes to any placement memorandum already filed with the Board can be made only if

(a) a copy of the placement memorandum indicating the changes is filed with the Board; and
(b) within twenty-one days of such filing, the Board has not communicated any objections or observations on the said amendments or changes.

Maintenance of books and records.

(1) Every venture capital fund shall maintain for a period of ten years books of accounts, records and documents which shall give a true and fair picture of the state of affairs of the venture capital fund.
(2) Every venture capital fund shall intimate the Board, in writing, the place where the books, records and documents referred to in sub-regulation (1) are being maintained.

Power to call for information

(1) The Board may at any time call for any information from a venture capital fund with respect to any matter relating to its activity as a venture capital fund.
(2) Where any information is called for under sub-regulation (1) it shall be furnished to the Board within fifteen days.

Submission of reports to the Board

The Board may at any time call upon the venture capital fund to file such reports as the Board may desire with regard to the activities carried on by the venture capital fund.

Winding up

(1) A scheme of a venture capital fund set up as a trust shall be wound up,
(a) when the period of the scheme, if any, mentioned in the placement memorandum is over;
(b) if it is the opinion of the trustees or the trustee company, as the case may be, that the scheme shall be wound up in the interests of investors in the units;
(c) if seventy-five per cent of the investors in the scheme pass a resolution at a meeting of unit holders that the scheme be wound up ; or
(d) if the Board so directs in the interests of investors.
(2) A venture capital fund set up as a company shall be wound up in accordance with the provisions of the Companies Act. 1956 (1 of 1956).

(3) The trustees or trustee company of the venture capital fund set up as a trust shall intimate the Board and investors of the circumstances leading to the winding up of the scheme under sub-regulation (1).

Effect of winding up

(1) On and from the date of intimation, no further investments shall be made on behalf of the scheme so wound up.

(2) Within three months from the date of intimation the assets of the scheme shall be liquidated, and the proceeds accruing to investors in the scheme distributed to them after satisfying all liabilities.

IV. Inspection and investigation

Board's right to inspect or investigate

(1) The Board may appoint one or more persons as inspecting or investigating officer to undertake inspection or investigation of the books of accounts, records and documents relating to a venture capital fund for any of the following reasons, namely

(a) to ensure that the books of account, records and documents are being maintained by the venture capital fund in the manner specified in these regulations;

(b) to inspect or investigate into complaints received from investors, clients or any other person, on any matter having a bearing on the activities of the venture capital fund;

(c) to ascertain whether the provisions of the Act and these regulations are being complied with by the venture capital fund; and

(d) to inspect or investigate *suo motu* into the affairs of a venture capital fund, in the interest of the securities market or in the interest of investors.

Notice before inspection or investigation

(1) Before ordering an inspection or investigation the Board shall give not less than ten days notice to the venture capital fund.

(2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of the investors no such notice should be given, it may by an order in writing direct that the inspection or investigation of the affairs of the venture capital fund be taken up without such notice.

(3) During the course of an inspection or investigation, the venture capital fund against whom the inspection or investigation is being carried out shall be bound to discharge its obligations as given below.

Obligations of venture capital fund on inspection or investigation by the Board.

(1) It shall be the duty of the venture capital fund whose affairs are being inspected or investigated, and of every director, officer and employee thereof, of its asset management company, if any, and of its trustees or directors or the directors of the trustee company, if any, to produce before the inspecting or investigating officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to the venture capital fund, as the inspecting or investigating officer may require, within such reasonable period as the inspecting officers may specify. .

(2) The venture capital fund shall allow the inspecting or investigating officer to have reasonable access to the premises occupied by such venture capital fund

or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the venture capital fund or such other person and also provide copies of documents or other materials which, in the opinion of the inspecting or investigation, as the case may be.

(3) The inspecting or investigating officer, in the course of inspection or investigation shall be entitled to examine or to record the statements of any director, officer or employee of the venture capital fund.

(4) It shall be the duty of every director, officer or employee, trustee or director of the trustee company of the venture capital fund to give to the inspecting or investigating officer all assistance in connection with the inspection or investigation, which the inspecting or investigating officer may reasonably require.

Submission of Report to the Board.

The inspecting or investigating officer shall, as soon as possible, on completion of the inspection or investigation submit an inspection or investigation report to the Board: Provided that if directed to do so by the Board, he may submit an interim report.

Communication of findings, etc. to the venture capital fund

(1) The Board shall, after consideration of the inspection or investigation report or the interim report communicate the findings of the inspection officer to the venture capital fund and give him an opportunity of being heard.

(2) On receipt of the reply if any, from the venture capital fund, the Board may call upon the venture capital fund to take such measures as the Board may deem fit in the interest of the securities market and for the due compliance with the provisions of the Act and these regulations.

V Procedure for action in case of default

Suspension of certificate. The Board may suspend the certificate granted to a venture capital fund where the venture capital fund:

(a) contravenes any of the provisions of the Act or these regulations;

(b) fails to furnish any information relating to its activity as a venture capital fund as required by the Board;

(c) furnishes to the Board information which is false or misleading in any material particular;

(d) does not submit periodic returns or reports as required by the Board;

(e) does "not co-operate in any enquiry, inspection or investigation conducted by the Board;

(f) fails to resolve the complaints of investors or fails to give a satisfactory reply to the Board in this behalf.

Cancellation of certificate. The Board may cancel the certificate granted to a venture capital fund

(a) when the venture capital fund is guilty of fraud or has been convicted of an offence involving moral turpitude; "

(b) the venture capital fund has been guilty of repeated defaults of the nature. Explanation - In this regulation, "fraud" has the same meaning as is assigned to it in section 17 of the Indian Contract Act, 1972 (9 of 1872) ; or

(c) contravenes any of the provisions of the Act or these regulations.

Manner of making order of cancellation or suspension-

No order of suspension or cancellation of certificate shall be made by the Board, except after holding an enquiry.

Manner of holding enquiry before suspension or cancellation

(1) For the purpose of holding an enquiry the Board may appoint one or more enquiry officers.

(2) The enquiry officer shall issue to the venture capital fund, at its registered office or its principal place of business, a notice setting out the grounds which on action is proposed to be taken against it and calling upon it to show cause against such action within a period of fourteen days from the date of receipt of the notice.

(3) The venture capital fund may, within fourteen days from the date of receipt of such notice, furnish to the enquiry officer a written reply, together with copies of documentary or other evidence relied on by it or sought by the Board from the venture capital fund.

(4) The enquiry officer shall give a reasonable opportunity of hearing to the venture capital fund to enable him to make submission in support of its reply made under sub-regulation (3).

(5) Before the enquiry officer, the venture capital fund may appear through any person duly authorised by the venture capital fund: Provided that not lawyer or advocate shall be permitted to represent the venture capital fund at the enquiry: Provided further that where a lawyer or an advocate has been appointed by the Board as a presenting officer under sub-regulation (6), it shall be lawful f6r the venture capital fund to present its case through a lawyer or advocate.

(6) The enquiry officer may, if he considers it necessary, ask the Board to appoint a presenting officer to present its case.

(7) The enquiry officer shall, after taking into account all relevant facts and submissions made by the venture capital fund, submit a report to the Board and recommend the penal action, if any, to be taken against the venture capital fund as also the grounds on which the proposed action is justified.

Show-cause notice and order

(1) On receipt of the report from the enquiry officer, the Board shall consider the same and may issue to the venture capital fund a show-cause notice as to why the penal action as proposed by the enquiry officer should not be taken against it.

(2) The venture capital fund shall, within fourteen days of the date of the receipt of the show-cause notice, send a reply to the Board. .

(3) The Board, after considering the reply, if any, of the venture capital fund, shall, as soon as possible pass such order as it deems fit.

Effect of suspension and cancellation of certificate

(1) On and from the date of the suspension of the certificate, the venture capital fund shall cease to carryon any activity as a venture capital fund during the period of suspension, and shall be subject to such directions of the Board with regard to any records, documents or securities that may be in its custody or control, relating to its activities as venture capital fund, as the Board may specify.

(2) On and from the date of cancellation of the certificate, the venture capital fund shall, with immediate effect, cease to carryon any activity as a venture capital fund, and shall be subject to such directions of the Board with regard to the transfer of records, documents or securities that may be in its custody or control, relating to its activities as venture capital fund, as the Board may specify.

Publication of order of suspension or cancellation

The order of suspension or cancellation of certificate passed may be published by the Board in two newspapers.

VENTURE CAPITAL IN INDIA

Globalisation may or may not have shrunk distance, but it certainly appears to have compressed time. After reading up on the venture capital industry in the US, it appears that what should have been a 10-year parole, a period of introspection about idiotic ideas let loose, has now been shortened to just four years. Venture capital is back in fashion, and perhaps with a difference. Comments from industry leaders suggest that a critical lesson in humility has been imbibed and the wild guys of the fraternity have been thrown out.

Who can argue with "We have learnt from our mistakes" or "Technology by itself is insufficient to create wealth, what matters is its innovative usage." This we-have-been-reformed air almost makes you believe that the initial frenzy leading up to the dotcom bust of 2000 is over and a process of sensible recomposition has begun. It all sounds so unexceptionable, so reasonable and so really polite.

But just a few scratches below the surface, you still get some stuff that either makes no sense or is just old wine in new bottles. Instead of "eyeballs" and "angel investors", the new terms are "audience management" and "permission filtering technology." You still get the sense that many of these guys are overloaded with money, off on the hunt for the next Big Idea, and are having a jolly good time just trying to be different for the sake of it.

I came across an interesting study: in the US, from 1992 to 1996, about $10 billion per year of venture capital was invested, producing on average 25-40 per cent annual rates of return. Those were good years. But then came the bad. From 1997 to 2001, the amount per year soared, reaching $70 billion in 2000, but the returns became negative. Nobody knows exactly how much in the negative, since there is a cloak of secrecy, but estimates range from 10 to 30 per cent in the red. Of course, some of this has to do with the tanking of US equity markets, but many were just plain bad investments.

In India, reliable estimates of VC funding are also difficult, mostly because not all that is reported is real and because rules allow many VC transactions to fall outside official statistics by making them indistinguishable from routine foreign investment. Still, there is broad agreement that VC funding in India in the calendar year 2003 was in the $500-600 million range, a sharp drop from $1.1 billion in 2002 and $900 million in 2001. Over 80 per cent new VC investment in India is in profitable companies rather than start-ups, with Internet companies clearly out of favour and BPO, media, entertainment and healthcare emerging as the new stars.

But Indian VC investment, for all its brouhaha, is essentially small, far less than China and Japan, and far less exciting. In fact, India has now slipped to the 5th position (from 3rd place in 2002) in Asia. More than the dotcom bust, this is perhaps due to the belated realisation that India remains an untested if not shaky market, and that success is often shaped by a combination of social circumstance and government role.

Take vaccines for instance, where a number of firms are in the race. On surface, the market opportunity looks huge; after all, infant mortality is high in India, over 3 million children under the age of five die each year and one in every 15 persons is a carrier of some immunisable disease. But while vaccine sales are robust and growing, around 20 per cent annually, they have hardly shown the dramatic growth that was projected by many venture capitalists.

Why? Because government is still the largest buyer. Official procurement remains mired in bureaucracy and corruption, while refrigeration and medical infrastructure needed for an effective immunisation programme simply does not exist in the far reaches of the country. The bottomline is that no matter how fantastic a discovery, a new vaccine will enjoy only limited market penetration due to the meagre resources of the public health system.

Venture and technology people (there is an 80 per cent overlap) are not stupid but they operate under far less checks and balances than do others. The business by its nature is very lonely, the rush to spot novel ideas and emerging technologies is both consuming and seductive, and there are few markers to help along the way. All these push VCs to believing in their own destiny. Confidence and risk-taking are essential for creating wealth, but not if you act as if you just had a conversation with God. Combined Indian industry estimates speak of reaching $1.5 billion financing in 2004, but more than quantity we need to focus on the quality and impact of this capital.

Venture Capital funding is different from traditional sources of financing. Finance innovation ideas have potential for high growth but with inherent uncertainties. This makes it a high-risk, high return investment for venture capitalists. Apart from finance, venture capitalists provide networking, management and marketing support as well. In the broadest sense, therefore, venture capital connotes risk finance as well as managerial support.

In the global venture capital industry, investors and funded firms work closely together in an enabling environment that allows entrepreneurs to focus on value creating ideas and venture capitalists to drive the industry by the levers of control in return for the provision of capital, skills, information and complementary resources. This very blend of risk financing and hand holding of entrepreneurs by venture capitalists creates an environment particularly suitable for 200,000 and so engineer graduates from Government and private-run colleges in India.

Scientific, technological and knowledge-based ideas properly supported by venture capital can be propelled into a powerful engine of economic growth and wealth creation in a sustainable manner. In various developed and developing economies venture capital has played a significant developmental role.

India, along with Israel, Taiwan and the United States, is recognized for its globally competitive high technology and human capital. The success India has achieved

particularly in software and information technology against several odds such as inadequate infrastructure, expensive hardware, restricted access to foreign resources and limited domestic demand, is a pointer to the hidden potential it has in the field of knowledge and technology based industry.

India has the second largest English speaking scientific and technical manpower in the world. Some of the management (IIMs) and technology institutes (IITs) in India are globally known as centres of excellence. Every year thousands of young people specialize through diploma courses in computers and other technical areas. Management institutes produce 40,000 management graduates annually. Given this quality and magnitude of human capital India's potential to create enterprises is unlimited.

In Silicon Valley, these very Indians have proved their potential and have carved out a prominent place in terms of wealth creation as well as credibility. There are innumerable well-known success stories of successful Indians backed by a venture capital environment in Silicon Valley and elsewhere in US, supporting their innovation and invention. At least 30 percent of the start-up enterprises in Silicon Valley are started / backed by Indians.

With the inherent skills and manpower that India has, it can be easily predicted that software exports will thrive with an estimated 50 percent growth per annum. The market capitalization of the listed software companies comprises of approximately 25 percent of the total market capitalization. Also greater visibility of the Indian companies globally is evident.

Given such vast potential, which is, not only confined to IT and software but also in other sectors like biotechnology, telecommunications, media and entertainment, medical and health etc., venture capital industry is playing and shall continue to play a catalyst's role in industrial development.

Thus, venture capital is valuable not only because it makes risk capital available at the early stages of a project but also because of the expertise of venture capitalist that leads to superior product development. And the big focus of venture capital worldwide is - technology.

VCs as a whole invested US$ 79.9 billion in the first three quarters of 2000, a 137 percent increase over the corresponding period during 1999. Out of this, technology firms reportedly got around 75 percent. Besides this huge supply from organised venture funds there is an even larger pool of "angel" funds provided by private investors. In 2000, it was expected that angel investment would be of the order of US$ 105 billion, thus making the total "at-risk" investment of US$ 185 billion in high-end technology ventures in a single year.

By contrast, in India, cumulative disbursements to date are not more than US$ 950 million, of which technology firms have received about 52 percent.

Venture Finance Glossary

Angel Financing Capital raised for a startup company from angel investors. The capital is generally used as seed money.

Angel Investors Angels are individual who include professional investors, retired executives with business experience and money to invest, or high net worth individuals looking for investment opportunities.

Affiliate A venture firm that is an associate or subsidiary to commercial banks, investment banks or insurance company. They make investments on behalf of outside investors or parent company's client.

Balanced Funding A venture fund investment strategy that includes the investment in portfolio companies at a variety of stages of development.

Bootstrapping A means of finding creative ways to support a startup business until it turns profitable. This method may include negotiating delayed payment to suppliers and advances from potential partners and customers.

Business Plan It is a statement of goals, and how to achieve those goals, and rewards the business will reap when those goals are met.

Buyout Financing Investment intended to support the management acquire a product line or business.

Capital (or Assets) Under Management The amount of capital available to a fund management team for venture investments.

Corporate strategic investors When you enter into a strategic partnership with another corporation, which will then extend finance to you, the firm, which provides the finance, is known as a corporate strategic investor. Such business agreements are referred to as strategic alliances or corporate partnerships.

Corporate Venturing A form of investing by big corporations in opportunities that are congruent with its strategic mission or that will provide business synergy.

Cost of Capital The rate of return required by investors on the capital provided by them.

Early Stage Financing Financing in seed stage, startup stage or first stage of a project.

Entrepreneur One who pursues new business opportunities and assumes inherent risk.

Equity Ownership in a company. While bonds represent debt, stocks represent equity.

Exit Option Options available for venture capital firms to liquidate its holdings to realize capital gains on their investment. Options depend on the exit climate including market conditions and industry trends.

Exit Strategy Strategy adopted by venture capitalists to liquidate its holding to realize capital gains on their investments. It includes providing for a stock buy-back by another firm, arranging a public offering of stock and providing for a merger with a larger firm.

Expansion Stage Financing Financing in second stage, third stage and mezzanine stage of a project.

First Stage Financing Financing provided when the firm has begun production and need additional fund for sales.

Flexibility This ability of a firm to raise further capital from any source it wishes to tap to meet the future financing needs.

Founder Capital It refers to the individuals own assets including bank balance, certificates of deposit, shares and bonds, cash value in insurance policies, real estate, pension funds, etc.

Fund Size The total amount of capital committed by the investors of a venture capital fund.
Initial Public Offering An issue of new stock by a once private company to transform itself into a publicly held one. Many entrepreneurs regard a successful initial public offering (IPO) as the conventional route to secure finance.
Institutional Investors Organizations whose primary purpose is to invest their own assets or those entrusted to them by others.
Interest The cost of borrowing money.
Investment The use of money for the purpose of making more money, to gain income or increase capital, or both.
Investment Philosophy The stated investment approach or focus of a fund manager/firm.
Later Stage Financing Financing in third stage and mezzanine stage of a project.
Leveraged Buyout (LBO) A takeover of a company, using a combination of equity and borrowed fund. Generally, the target company's assets act as the collateral for the loans taken out by the acquiring group. The acquiring group then repays the loan from the cash flow of the acquired company.
Love Money It is the finance obtained from family, relatives and friends. A common source of founder capital.
Mezzanine Financing Financing also called bridge financing, intended for additional expansion of market before the company goes public. Often this financing is structured so that it can be repaid from the proceeds of an IPO.
Partnering Partnering is a business arrangement with an investor, who intends to gain a quick access to new product/service.
Post-money Valuation The valuation of a company immediately after the most recent round of financing.
Pre-money Valuation The Valuation of a company just prior to the most recent round of financing.
Professionally Managed Pools A type of venture firm which functions in similar term as traditional partners do but the pool is made of institutional money. These funds are typically organized as fixed life partnerships, usually having a life of ten years.
Proposed Financing Statement of the amount of funds required to move the project from the initial concept stage till the revenue stage. It briefs on how money will be raised in parts and how the proceeds will be used.
Recapitalization The reorganization of a company's capital structure. It can be an alternative exit strategy for venture capitalists.
Seed Money The combination of founder capital and love money. Generally, the amount of seed money raised is small and is suitable for early stage financing.
Second Stage Financing Financing the working capital requirement for initial expansion of company that is producing and shipping.
Seed Stage Financing An investment of relatively small size, made at a very early stage of the project where typically a little more than a prototype exist. An investment before there is any real product.
Startup Financing Financing provided for those companies, ready with a business plan, to support product and market development works.
Third Stage Financing Financing provided for major expansion of company that is breaking even and is growing.

Traditional Partnership A type of venture firm wherein, wealthy individuals to manage a portion of their fund establish a partnership. These are private individual firms having no affiliation with any financial institution. Generally investments are made in small companies.
Turnaround Financing Financing with the intention of turning around the company at the time of financial or operational difficulty.
Venture capital A main source of financing used to fund startups that do not have access to capital markets. It involves investing in high risk and high return projects that are usually innovative in nature and involving lot of uncertainties.
Venture Capitalist These are individuals or firm managers who fund startups for equity stake in the business. These are professional investors with vast experience, good contacts and sound business skills, which they bring along with money. They often look for highly profitable businesses that guarantee an immediate return on their investment.
Yield The amount of money returned to investors on their investments. Also known as rate of return.

VENTURE CAPITAL

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INTRODUCTION

A number of technocrats are seeking to set up shop on their own and capitalize on opportunities. In the highly dynamic economic climate that surrounds us today, few 'traditional' business models may survive. Countries across the globe are realizing that it is not the conglomerates and the gigantic corporations that fuel economic growth any more. The essence of any economy, today is the small and medium enterprises. For example, in the US, 50% of the exports, are created by companies with less than 20 employees and only 7% are created by companies with 500 or more employees.
This growing trend can be attributed to rapid advances in technology in the last decade. Knowledge driven industries like info-tech, health-care, entertainment and services have become the cynosure of bourses worldwide. In these sectors, it is innovation and technical capability that are big business-drivers. This is a paradigm shift from the earlier physical production and 'economies of scale' model.
However, starting an enterprise is never easy. There are a number of parameters that contribute to its success or downfall. Experience, integrity, prudence and a clear understanding of the market are among the sought after qualities of a promoter. However, there are other factors, which lie beyond the control of the entrepreneur. Prominent among these is the timely infusion of funds. This is where the venture capitalist comes in, with money, business sense and a lot more.
What Is Venture Capital?
Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capitalists generally:

- Finance new and rapidly growing companies
- Purchase equity securities
- Assist in the development of new products or services
- Add value to the company through active participation
- Take higher risks with the expectation of higher rewards
- Have a long-term orientation

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. They also actively work with the company's management, especially with contacts and strategy formulation.

Venture capitalists mitigate the risk of investing by developing a portfolio of young companies in a single venture fund. Many times they co-invest with other professional venture capital firms. In addition, many venture partnerships manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development. (Source: *National Venture Capital Association 1999 Yearbook).*

In India, these funds are governed by the Securities and Exchange Board of India (SEBI) guidelines. According to this, venture capital fund means a fund established in the form of a company or trust, which raises monies through loans, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations. (Source: *SEBI (Venture Capital Funds) Regulations, 1996)*

Investment Philosophy

The basic principal underlying venture capital – invest in high-risk projects with the anticipation of high returns. These funds are then invested in several fledging enterprises, which require funding, but are unable to access it through the conventional sources such as banks and financial institutions. Typically first generation entrepreneurs start such enterprises. Such enterprises generally do not have any major collateral to offer as security, hence banks and financial institutions are averse to funding them. Venture capital funding may be by way of investment in the equity of the new enterprise or a combination of debt and equity, though equity is the most preferred route.

Since most of the ventures financed through this route are in new areas (worldwide venture capital follows "hot industries" like infotech, electronics and biotechnology), the probability of success is very low. All projects financed do not give a high return. Some projects fail and some give moderate returns. The investment, however, is a long-term risk capital as such projects normally take 3 to 7 years to generate substantial returns. Venture capitalists offer "more than money" to the venture and

seek to add value to the investee unit by active participation in its management. They monitor and evaluate the project on a continuous basis.

The venture capitalist is however not worried about failure of an investee company, because the deal which succeeds, nets a very high return on his investments – high enough to make up for the losses sustained in unsuccessful projects. The returns generally come in the form of selling the stocks when they get listed on the stock exchange or by a timely sale of his stake in the company to a strategic buyer. The idea is to cash in on an increased appreciation of the share value of the company at the time of disinvestment in the investee company. If the venture fails (more often than not), the entire amount gets written off. Probably, that is one reason why venture capitalists assess several projects and invest only in a handful after careful scrutiny of the management and marketability of the project.

To conclude, a venture financier is one who funds a start up company, in most cases promoted by a first generation technocrat promoter with equity. A venture capitalist is not a lender, but an equity partner. He cannot survive on minimalism. He is driven by maximization: wealth maximization. Venture capitalists are sources of expertise for the companies they finance. Exit is preferably through listing on stock exchanges. This method has been extremely successful in USA, and venture funds have been credited with the success of technology companies in Silicon Valley. The entire technology industry thrives on it.

A Brief History

The concept of venture capital is not new. Venture capitalists often relate the story of Christopher Columbus. In the fifteenth century, he sought to travel westwards instead of eastwards from Europe and so planned to reach India. His far-fetched idea did not find favor with the King of Portugal, who refused to finance him. Finally, Queen Isabella of Spain, decided to fund him and the voyages of Christopher Columbus are now empanelled in history.

The modern venture capital industry began taking shape in the post – World War II years. It is often said that people decide to become entrepreneurs because they see role models in *other* people who have become successful entrepreneurs. Much the same thing can be said about venture capitalists. The earliest members of the organized venture capital industry had several role models, including these three:

American Research and Development Corporation, formed in 1946, whose biggest success was Digital Equipment. The founder of ARD was General Georges Doroit, a French-born military man who is considered "the father of venture capital." In the 1950s, he taught at the Harvard Business School. His lectures on the importance of risk capital were considered quirky by the rest of the faculty, who concentrated on conventional corporate management.

J.H. Whitney & Co, also formed in 1946, one of whose early hits was Minute Maid juice. Jock Whitney is considered one of the industry's founders.

The Rockefeller Family, and in particular, L S Rockefeller, one of whose earliest investments was in Eastern Airlines, which is now defunct but was one of the earliest commercial airlines.

The Second World War produced an abundance of technological innovation, primarily with military applications. They include, for example, some of the earliest work on micro circuitry. Indeed, J.H. Whitney's investment in Minute Maid was intended to commercialize an orange juice concentrate that had been developed to provide nourishment for troops in the field.

In the mid-1950s, the U.S. federal government wanted to speed the development of advanced technologies. In 1957, the Federal Reserve System conducted a study that concluded that a shortage of entrepreneurial financing was a chief obstacle to the development of what it called "entrepreneurial businesses." As a response this a number of Small Business Investment Companies (SBIC) were established to "leverage" their private capital by borrowing from the federal government at below-market interest rates. Soon commercial banks were allowed to form SBICs and within four years, nearly 600 SBICs were in operation.

At the same time a number of venture capital firms were forming private partnerships outside the SBIC format. These partnerships added to the venture capitalist's toolkit, by offering a degree of flexibility that SBICs lack. Within a decade, private venture capital partnerships passed SBICs in total capital under management.

The 1960s saw a tremendous bull IPO market that allowed venture capital firms to demonstrate their ability to create companies and produce huge investment returns. For example, when Digital Equipment went public in 1968 it provided ARD with 101% annualized Return on Investment (ROI). The US$70,000 Digital invested to start the company in 1959 had a market value of US$37mn. As a result, venture capital became a hot market, particularly for wealthy individuals and families. However, it was still considered too risky for institutional investors.

In the 1970s, though, venture capital suffered a double-whammy. First, a red-hot IPO market brought over 1,000 venture-backed companies to market in 1968, the public markets went into a seven-year slump. There were a lot of disappointed stock market investors and a lot of disappointed venture capital investors too. Then in 1974, after Congress legislation against the abuse of pension fund money, all high-risk investment of these funds was halted. As a result of poor public market and the pension fund legislation, venture capital fund raising hit rock bottom in 1975.

Well, things could only get better from there. Beginning in 1978, a series of legislative and regulatory changes gradually improved the climate for venture investing. First Congress slashed the capital gains tax rate to 28% from 49.5%. Then the Labor Department issued a clarification that eliminated the pension funds act as an obstacle to venture investing. At around the same time, there were a number of high-profile IPOs by venture-backed companies. These included Federal Express in 1978, and Apple Computer and Genetech Inc in 1981. This rekindled interest in venture capital on the part of wealthy families and institutional investors. Indeed, in the 1980s, the venture capital industry began its greatest period of growth. In 1980, venture firms raised and invested less than US$600 million. That number soared to nearly US$4bn by 1987. The decade also marked the explosion in the buy-out business.

The late 1980s marked the transition of the primary source of venture capital funds from wealthy individuals and families to endowment, pension and other institutional funds. The surge in capital in the 1980s had predictable results. Returns on venture capital investments plunged. Many investors went into the funds anticipating returns of 30% or higher. That was probably an unrealistic expectation to begin with. The consensus today is that private equity investments generally should give the investor an internal rate of return something to the order of 15% to 25%, depending upon the degree of risk the firm is taking.

However, by 1990, the average long-term return on venture capital funds fell below 8%, leading to yet another downturn in venture funding. Disappointed families and

institutions withdrew from venture investing in droves in the 1989-91 period. The economic recovery and the IPO boom of 1991-94 have gone a long way towards reversing the trend in both private equity investment performance and partnership commitments.

In 1998, the venture capital industry in the United States continued its seventh straight year of growth. It raised US$25bn in committed capital for investments by venture firms, who invested over US$16bn into domestic growth companies in all sectors, but primarily focused on information technology.

Venture Capital In India

Most of the success stories of the popular Indian entrepreneurs like the Ambanis and Tatas had little to do with a professionally backed up investment at an early stage. In fact, till very recently, for an entrepreneur starting off on his own personal savings or loans raised through personal contacts/financial institutions.

Traditionally, the role of venture capital was an extension of the developmental financial institutions like IDBI, ICICI, SIDBI and State Finance Corporations (SFCs). The first origins of modern Venture Capital in India can be traced to the setting up of a Technology Development Fund (TDF) in the year 1987-88, through the levy of a cess on all technology import payments. TDF was meant to provide financial assistance– to innovative and high-risk technological programs through the Industrial Development Bank of India. This measure was followed up in November 1988, by the issue of guidelines by the (then) Controller of Capital Issues (CCI). These stipulated the framework for the establishment and operation of funds/companies that could avail of the fiscal benefits extended to them.

However, another form of (ad?)venture capital which was unique to Indian conditions also existed. That was funding of green-field projects by the small investor by subscribing to the Initial Public Offering (IPO) of the companies. Companies like Jindal Vijaynagar Steel, which raised money even before they started constructing their plants, were established through this route.

The industry's growth in India can be considered in two phases. The first phase was spurred on soon after the liberalization process began in 1991. According to former finance minister and harbinger of economic reform in the country, Manmohan Singh, the government had recognized the need for venture capital as early as 1988. That was the year in which the Technical Development and Information Corporation of India (TDICI, now ICICI ventures) was set up, soon followed by Gujarat Venture Finance Limited (GVFL). Both these organizations were promoted by financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals. Though an attempt was also made to raise funds from the public and fund new ventures, the venture capitalists had hardly any impact on the economic scenario for the next eight years.

However, it was realized that the concept of venture capital funding needed to be institutionalized and regulated. This funding requires different skills in assessing the proposal and monitoring the progress of the fledging enterprise. In 1996, the Securities and Exchange Board of India (SEBI) came out with guidelines for venture capital funds has to adhere to, in order to carry out activities in India. This was the beginning of the second phase in the growth of venture capital in India. The move liberated the industry from a number of bureaucratic hassles and paved the path for the entry of a number of foreign funds into India. Increased competition brought with

it greater access to capital and professional business practices from the most mature markets.

There are a number of funds, which are currently operational in India and involved in funding start-up ventures. Most of them are not true venture funds, as they do not fund start-ups. What they do is provide mezzanine or bridge funding and are better known as private equity players. However, there is a strong optimistic undertone in the air. With the Indian knowledge industry finally showing signs of readiness towards competing globally and awareness of venture capitalists among entrepreneurs higher than ever before, the stage seems all set for an overdrive.

The Indian Venture Capital Association (IVCA), is the nodal center for all venture activity in the country. The association was set up in 1992 and over the last few years, has built up an impressive database. According to the IVCA, the pool of funds available for investment to its 20 members in 1997 was Rs25.6bn. Out of this, Rs10 bn had been invested in 691 projects.

Certain venture capital funds are Industry specific(ie they fund enterprises only in certain industries such as pharmaceuticals, infotech or food processing) whereas others may have a much wider spectrum. Again, certain funds may have a geographic focus – like Uttar Pradesh, Maharashtra, Kerala, etc whereas others may fund across different territories. The funds may be either close-endedschemes (with a fixed period of maturity) or open-ended.

Classification

Venture funds in India can be classified on the basis of

Genesis

Financial Institutions Led By ICICI Ventures, RCTC, ILFS, etc.

- Private venture funds like Indus, etc.
- Regional funds like Warburg Pincus, JF Electra (mostly operating out of Hong Kong).
- Regional funds dedicated to India like Draper, Walden, etc.
- Offshore funds like Barings, TCW, HSBC, etc.
- Corporate ventures like Intel.

To this list we can add Angels like Sivan Securities, Atul Choksey (ex Asian Paints) and others. Merchant bankers and NBFCs who specialized in "bought out" deals also fund companies. Most merchant bankers led by Enam Securities now invest in IT companies.

Investment Philosophy

Early stage funding is avoided by most funds apart from ICICI ventures, Draper, SIDBI and Angels.

Funding growth or mezzanine funding till pre IPO is the segment where most players operate. In this context, most funds in India are private equity investors.

Size Of Investment

The size of investment is generally less than US$1mn, US$1-5mn, US$5-10mn, and greater than US$10mn. As most funds are of a private equity kind, size of investments has been increasing. IT companies generally require funds of about Rs30-40mn in an early stage which fall outside funding limits of most funds and that is why the government is promoting schemes to fund start ups in general, and in IT in particular.

Value Addition

The venture funds can have a totally "hands on" approach towards their investment like Draper or "hands off" like Chase. ICICI Ventures falls in the limited exposure

category. In general, venture funds who fund seed or start ups have a closer interaction with the companies and advice on strategy, etc while the private equity funds treat their exposure like any other listed investment. This is partially justified, as they tend to invest in more mature stories.

A list of the members registered with the IVCA as of June 1999, has been provided in the Annexure. However, in addition to the organized sector, there are a number of players operating in India whose activity is not monitored by the association. Add together the infusion of funds by overseas funds, private individuals, 'angel' investors and a host of financial intermediaries and the total pool of Indian Venture Capital today, stands at Rs50bn, according to industry estimates!

The primary markets in the country have remained depressed for quite some time now. In the last two years, there have been just 74 initial public offerings (IPOs) at the stock exchanges, leading to an investment of just Rs14.24bn. That's less than 12% of the money raised in the previous two years. That makes the conservative estimate of Rs36bn invested in companies through the Venture Capital/Private Equity route all the more significant.

Some of the companies that have received funding through this route include:

- Mastek, one of the oldest software houses in India
- Geometric Software, a producer of software solutions for the CAD/CAM market
- Ruksun Software, Pune-based software consultancy
- SQL Star, Hyderabad based training and software development company
- Microland, networking hardware and services company based in Bangalore
- Satyam Infoway, the first private ISP in India
- Hinditron, makers of embedded software
- PowerTel Boca, distributor of telecomputing products for the Indian market
- Rediff on the Net, Indian website featuring electronic shopping, news, chat, etc
- Entevo, security and enterprise resource management software products
- Planetasia.com, Microland's subsidiary, one of India's leading portals
- Torrent Networking, pioneer of Gigabit-scaled IP routers for inter/intra nets
- Selectica, provider of interactive software selection
- Yantra, ITLInfosys' US subsidiary, solutions for supply chain management

Though the infotech companies are among the most favored by venture capitalists, companies from other sectors also feature equally in their portfolios. The healthcare sector with pharmaceutical, medical appliances and biotechnology industries also get much attention in India. With the deregulation of the telecom sector, telecommunications industries like Zip Telecom and media companies like UTV and Television Eighteen have joined the list of favorites. So far, these trends have been in keeping with the global course.

However, recent developments have shown that India is maturing into a more developed marketplace, unconventional investments in a gamut of industries have sprung up all over the country. This includes:

Indus League Clothing, a company set up by eight former employees of readymade garments giant Madura, who set up shop on their own to develop a unique virtual organization that will license global apparel brands and sell them, without owning any manufacturing units. They dream to build a network of 2,500 outlets in three years and to be among the top three readymade brands.

Shoppers Stop, Mumbai's premier departmental store innovates with retailing and decides to go global. This deal is facing some problems in getting regulatory approvals.

Airfreight, the courier-company which has been growing at a rapid pace and needed funds for heavy investments in technology, networking and aircrafts.

Pizza Corner, a Chennai based pizza delivery company that is set to take on global giants like Pizza Hut and Dominos Pizza with its innovative servicing strategy.

Car designer Dilip Chhabria, who plans to turn his studio, where he remodels and overhauls cars into fancy designer pieces of automation, into a company with a turnover of Rs1.5bn (up from Rs40mn today).

Indian Scenario - A Statistical Snapshot

Contributors Of Funds

Contributors	Rs mn	Per cent
Foreign Institutional Investors	13,426.47	52.46%
All India Financial Institutions	6,252.90	24.43%
Multilateral Development Agencies	2,133.64	8.34%
Other Banks	1,541.00	6.02%
Foreign Investors	570	2.23%
Private Sector	412.53	1.61%
Public Sector	324.44	1.27%
Nationalized Banks	278.67	1.09%
Non Resident Indians	235.5	0.92%
State Financial Institutions	215	0.84%
Other Public	115.52	0.45%
Insurance Companies	85	0.33%
Mutual Funds	4.5	0.02%
Total	25,595.17	100.00%

Methods Of Financing

Instruments	Rs million	Per cent
Equity Shares	6,318.12	63.18
Redeemable Preference Shares	2,154.46	21.54
Non Convertible Debt	873.01	8.73
Convertible Instruments	580.02	5.8
Other Instruments	75.85	0.75
Total	10,000.46	100

Financing By Investment Stage

Investment Stages	Rs million	Number
Start-up	3,813.00	297
Later stage	3,338.99	154
Other early stage	1,825.77	124
Seed stage	963.2	107
Turnaround financing	59.5	9

Total	10,000.46	691

Financing By Industry

Industry	Rs million	Number
Industrial products, machinery	2,599.32	208
Computer Software	1,832	87
Consumer Related	1,412.74	58
Medical	623.8	44
Food, food processing	500.06	50
Other electronics	436.54	41
Tel & Data Communications	385.09	16
Biotechnology	376.46	30
Energy related	249.56	19
Computer Hardware	203.36	25
Miscellaneous	1,380.85	113
Total	10,000.46	691

Financing By States

Investment	Rs million	Number
Maharashtra	2,566	161
Tamil Nadu	1531	119
Andhra Pradesh	1372	89
Gujarat	1102	49
Karnataka	1046	93
West Bengal	312	22
Haryana	300	22
Delhi	294	21
Uttar Pradesh	283	29
Madhya Pradesh	231	2
Kerala	135	15
Goa	105	16
Rajasthan	87	11
Punjab	84	6
Orissa	35	5
Dadra & Nagar Haveli	32	1
Himachal Pradesh	28	3
Pondicherry	22	2
Bihar	16	3
Overseas	413	12
Total	9994	691

Source IVCA

Problems With VCs In The Indian Context

One can ask why venture funding is so successful in USA and faced a number of problems in India. The biggest problem was a mindset change from "collateral funding" to high risk high return funding. Most of the pioneers in the industry were people with credit background and exposure to manufacturing industries. Exposure to fast growing intellectual property business and services sector was almost zero. All these combined to a slow start to the industry. The other issues that led to such a situation include:

License Raj And The IPO Boom

Till early 90s, under the license raj regime, only commodity centric businesses thrived in a deficit situation. To fund a cement plant, venture capital is not needed. What was needed was ability to get a license and then get the project funded by the banks and DFIs. In most cases, the promoters were well-established industrial houses, with no apparent need for funds. Most of these entities were capable of raising funds from conventional sources, including term loans from institutions and equity markets.

Scalability

The Indian software segment has recorded an impressive growth over the last few years and earns large revenues from its export earnings, yet our share in the global market is less than 1 per cent. Within the software industry, the value chain ranges from body shopping at the bottom to strategic consulting at the top. Higher value addition and profitability as well as significant market presence take place at the higher end of the value chain. If the industry has to grow further and survive the flux it would only be through innovation. For any venture idea to succeed there should be a product that has a growing market with a scalable business model. The IT industry (which is most suited for venture funding because of its "ideas" nature) in India till recently had a service centric business model. Products developed for Indian markets lack scale.

Mindsets

Venture capital as an activity was virtually non-existent in India. Most venture capital companies want to provide capital on a secured debt basis, to established businesses with profitable operating histories. Most of the venture capital units were offshoots of financial institutions and banks and the lending mindset continued. True venture capital is capital that is used to help launch products and ideas of tomorrow. Abroad, this problem is solved by the presence of `angel investors'. They are typically wealthy individuals who not only provide venture finance but also help entrepreneurs to shape their business and make their venture successful.

Returns, Taxes and Regulations

There is a multiplicity of regulators like SEBI and RBI. Domestic venture funds are set up under the Indian Trusts Act of 1882 as per SEBI guidelines, while offshore funds routed through Mauritius follow RBI guidelines. Abroad, such funds are made under the Limited Partnership Act, which brings advantages in terms of taxation. The government must allow pension funds and insurance companies to invest in venture capitals as in USA where corporate contributions to venture funds are large.

Exit

The exit routes available to the venture capitalists were restricted to the IPO route. Before deregulation, pricing was dependent on the erstwhile CCI regulations. In general, all issues were under priced. Even now SEBI guidelines make it difficult for pricing issues for an easy exit. Given the failure of the OTCEI and the revised

guidelines, small companies could not hope for a BSE/ NSE listing. Given the dull market for mergers and acquisitions, strategic sale was also not available.

Valuation

The recent phenomenon is valuation mismatches. Thanks to the software boom, most promoters have sky high valuation expectations. Given this, it is difficult for deals to reach financial closure as promoters do not agree to a valuation. This coupled with the fancy for software stocks in the bourses means that most companies are preponing their IPOs. Consequently, the number and quality of deals available to the venture funds gets reduced.

Regulatory Issues

This chapter aims to give a bird's eye's view of the various guidelines a venture fund has to adhere to in India. There are a number of rules and regulation for venture capital and these would broadly come under either of the following heads:

- The Indian Trust Act, 1882 or the Company Act, 1956 depending on whether the fund is set up as a trust or a company. (In the US, a venture capital firm is normally set up as a limited liability partnership)
- The Foreign Investment Promotion Board (FIPB) and the Reserve Bank of India (RBI) in case of an offshore fund. These funds have to secure the permission of the FIPB while setting up in India and need a clearance from the RBI for any repatriation of income.
- The Central Board of Direct Taxation (CBDT) governs the issues pertaining to income tax on the proceeds from venture capital funding activity. The long term capital gains tax is at around 10% in India and the relevant clauses to venture capital may be found in Section 10 (subsection 23).
- The Securities and Exchange Board of India has come out with a set of guidelines attached in the annexure.

In addition to the above there are a number of arms of the Government of India – Ministry of Finance that may have to be approached in certain situations. Also intervention allied agencies like the Department of Electronics, the National Association of Software and Computers (NASSCOM) and various taskforces and standing committees is not uncommon.

Probably this explains why most of the funds prefer to take the easy way out by listing as offshore funds operating out of tax havens like Mauritius (where the Avoidance of Double Taxation Treaty, incomes may be freely repatriated).

Global Scenario In Brief

In the UK, more than 16,500 companies have received venture capital backing since 1983. In a survey carried out by the British Venture Capital Association and Coopers & Lybrand (now Price Waterhouse Coopers, over a period of four years from 1990-91 to 1994-95, on an average, venture-backed companies:

- Sales rose by 34 per cent per annum (Five times faster than that of the FT-SE 100 companies)
- Exports grew by 29 per cent
- Investment increased by 28 per cent
- As much as 88 per cent said that they benefited from their venture capital backers who provided "more than just money"
- Almost 90 per cent venture backed companies would have disappeared or would have grown less rapidly without Venture Capital

In the US, in 1997 venture capitals invested a record, US$11.4bn in nascent companies. According to VentureOne, San Francisco, CA,

- The surge in investments represented a 16 per cent increase over 1996
- Venture capitalists invested in 1,848 companies over the year, 162 more than in 1996

The Venture Capital pool in Hong Kong is 5.5 per cent of the country's GDP, with similar figures in Singapore and South Korea. India, Malaysia and Thailand attract large-scale investible funds from abroad.

The prosperity of many rapidly growing Australian technology companies can be directly attributed to venture capitalists, according to a research conducted on behalf of Price Waterhouse Coopers. The findings of the survey, companies in the development/ expansion stage, where the majority of the venture capital funding is directed, exhibited increased:

- Employment at an average annual rate of 9.5 per cent between 1993 and 1997
- Sales at an average rate of 12.1 per cent
- Profits at 34.9 per cent
- Exports at 15.2 per cent
- 52 per cent of the respondents viewed the importance of venture capital to growth of business as crucial
- 56 per cent considered venture capitalists as being a 'real partner'

Angels

Angels are important links in the entire process of venture capital funding. This is because they support a fledging enterprise at a very early stage – sometime even before commercialization of the product or service offering. Typically, an angel is an experienced industry-bred individual with high net worth.

Angels provide funding by "first round" financing for risky investments – risky because they are a young /start-up company or because their financial track record is unstable. This venture capital financing is typically used to prepare the company for "second round" financing in the form of an initial public offering (IPO). Example – A company may need "first round" financing to develop a new product line, (viz a new drug which would require significant research & development funding) or make a strategic acquisition to achieve certain levels of growth & stability.

It is important to choose the right Angel because they will sit on your Board of Directors, often for the duration of their investment and will assist in getting "second round" financing. When choosing an 'Angel', it is imperative to consider their experience in a relevant industry, reputation, qualifications and track record.

Angels are people with less money orientation, but who play an active role in making an early-stage company work. They are people with enough hands-on experience and are experts in their fields. They understand the field from an operational perspective. An entrepreneur needs this kind of expertise. He also needs money to make things happen. Angels bring both to the table of an entrepreneur.

There are a number of professionally qualified people, especially from IITs who had migrated to USA. Some of them have made their millions riding the IT boom in Silicon Valley. Having witnessed the maturity of the Silicon Valley into the global tech hotspot and thrived in the environment there, these individuals are rich in terms of financial resources and experience. They are the latest angels in the Indian industry.

The IndUS Entrepreneurs (TiE), a networking society that brings together highly influential Indians across the US was set up in 1992. The aim of the organization is to get the community together and to foster entrepreneurs and wealth creation. The idea was sparked off in 1992, when a group of Silicon Valley entrepreneurs with roots in the Indian sub-continent met by chance for a meeting with a visiting dignitary from India. A delayed flight kept the group waiting, and provided an opportunity for people to get to know one another. It turned out that most of the assembled invitees to the meeting had achieved varying degrees of entrepreneurial success. The group saw value in getting together on a regular basis to network with one another. Thus, the idea of TiE was born as a mechanism for high achievement-oriented IndUS entrepreneurs to network.

Over the years, a core group of about 10-15 individuals worked hard to establish the organization. Meeting at least once a month, successful veteran entrepreneurs, contributed as speakers, participants and mentors. Gradually, the group started attracting greater participation, and the TiE concept started gaining momentum. TiE membership has now grown to over 600 members, and chapters in Boston, Austin and Los Angeles. TiE is also supported by over 20 institutions that include leading Silicon Valley venture capital investors, law firms, accounting firms and banks.

Fifty percent of business plans submitted to venture capitalists in the Valley and outside is now from Indians and TiE can take the lion's share of the credit for this. What's more? About 30 per cent of the projects that are funded, are headed by Indians. As of 1998, over two dozen start-up companies have benefited from TiE, and two have already made successful IPOs.

TiE isn't about venture capitalist funding. It's about angel investing. The issue here is to identify a good idea that hasn't attracted any money, and then fund it the money coming from the member's own pockets. The environment is traditional in the sense of it following a gurukul environment of sorts, where the gurus transfer knowledge on business plans, management strategies and survival kits to new TiE members.

Some of the famous names include

- Vinod Dham, father of the Pentium chip and now the CEO of the Silicon Spice, one of the most closely watched start-ups in the Silicon Valley today.
- Sailesh Mehta, CEO & President of the US$15bn Providian Financial and the man who is using technology to re-order consumer finance.
- Kanwal Rekhi, one of the first Indians to become a big name in the valley; founder of Excelan, past CTO and member of Novell's board, now invests in a number of new ventures. He is the current chairman of the TiE.
- Prabhu Goel, ‘serial entrepreneur’, who has started three hi-tech companies so far and is on the board of five other companies as a private investor.
- Suhas Patil, who founded the semiconductor company Cirrus Logic in 1984.
- Prakash Agarwal, whose NeoMagic integrates memory and logic on a single chip. The six year old company already has a market share of 50%.
- K.B. Chandrashekhar, heads the US$200mn Exodus Communications, whose fiber optic network carries 30% of all Internet content traffic and whose servers host such popular websites such as Yahoo, Hotmail and Amazon.

Corporate Venturing

Even though corporate venturing is an attractive alternative, most companies find it difficult to establish systems, capabilities and cultures that make good venture capital firms. Corporate managers seldom have the same freedom to fund innovative projects

or to cancel them midstream. Their skills are honed for managing mature businesses and not nurturing start up companies. If a firm is to apply the venture capital model, it must understand the characteristics of the model and tailor its venture capital program to its own circumstances without losing sight of these essentials.

Success of venture capital firms rest on the following characteristics:

Focus on specific industry niches and look for business concepts that will

- Although corporate managers have a clear focus in their business, they run into ambiguity with venture programs. Their biggest challenge is to establish clear, prioritized objectives. Simply making a good financial return is not sufficient.
- Manage portfolios ruthlessly, abandon losers, whereas abandoning ventures has never been easy for large corporations, whose projects are underpinned by personal relationships, political concerns.
- Venture capital firms share several attributes with start up they fund. They tend to be small, flexible and quick to make decisions. They have flat hierarchies and rely heavily on equity and incentive pay.

Apple Computers established a venture fund in 1986 with the dual objectives of earning high financial return and supporting development of Macintosh software. They structured compensation mechanisms, decision criteria and operating procedures on those of top venture capital firms. While they considered Macintosh as an initial screening factor, its funding decisions were aimed at optimizing financial returns. The result was an IRR of 90 per cent but little success in improving the position of Macintosh.

New ventures can be powerful source of revenues, diversification and flexibility in rapidly changing environments. The company should create an environment that encourages venturing. An innovative culture cannot be transplanted but must evolve within the company. Venture investing requires different mindset from typical corporate investors.

How relevant is corporate venturing in the Indian scenario? The firms, which launched the successful corporate ventures had created new products in the market operating at the higher end of the value chain and had attained a certain size in the market. Most Indian companies are yet to move up the value chain and consolidate their position as players in the global market. Corporate venturing models would probably benefit Indian companies who are large players in the Indian market in another five to 10 years by enabling them to diversify and at the same time help start up companies. Multinationals led by Intel are the best examples of corporate venturing in an Indian context.

Financing Options In General

The possibility of raising a substantial part of project finances in India through both equity and debt instruments is among the key advantages of investing in India.

The Indian banking system has shown remarkable growth over the last two decades. The rapid growth and increasing complexity of the financial markets, especially the capital market have brought about measures for further development and improvement in the working of these markets. Banks and development financial institutions led by ICICI, IDBI and IFCI were providers of term loans for funding projects. The options were limited to conventional businesses, ie manufacturing centric. Services sector was ignored because of the "collateral" issue.

Equity was raised from the capital markets using the IPO route. The bull markets of the 90s, fuelled by Harshad Mehta and the FIIs, ensured that (ad)venture capital was easily available. Manufacturing companies exploited this to the full.

The services sector was ignored, like software, media, etc. Lack of understanding of these sectors was also responsible for the same. If we look back to 1991 or even 1992, the situation as regards financial outlay available to Indian software companies was poor. Most software companies found it extremely difficult to source seed capital, working capital or even venture capital. Most software companies started off undercapitalized, and had to rely on loans or overdraft facilities to provide working capital. This approach forced them to generate revenue in the short term, rather than investing in product development. The situation fortunately has changed.

The Venture Capital Process

Venture capitalists are a busy lot. This chapter aims to highlight the approach to an investor and the entire process that goes into the wooing the venture capital with your plan.

First, you need to work out a business plan. The business plan is a document that outlines the management team, product, marketing plan, capital costs and means of financing and profitability statements.

The venture capital investment process has variances/features that are context specific and vary from industry, timing and region. However, activities in a venture capital fund follow a typical sequence. The typical stages in an investment cycle are as below:

- Generating a deal flow
- Due diligence
- Investment valuation
- Pricing and structuring the deal
- Value Addition and monitoring
- Exit

Generating A Deal Flow

In generating a deal flow, the venture capital investor creates a pipeline of ‘deals’ or investment opportunities that he would consider for investing in. This is achieved primarily through plugging into an appropriate network. The most popular network obviously is the network of venture capital funds/investors. It is also common for venture capitals to develop working relationships with R&D institutions, academia, etc, which could potentially lead to business opportunities. Understandably the composition of the network would depend on the investment focus of the venture capital funds/company. Thus venture capital funds focussing on early stage technology based deals would develop a network of R&D centers working in those areas. The network is crucial to the success of the venture capital investor. It is almost imperative for the venture capital investor to receive a large number of investment proposals from which he can select a few good investment candidates finally. Successful venture capital investors in the USA examine hundreds of business plans in order to make three or four investments in a year.

It is important to note the difference between the profile of the investment opportunities that a venture capital would examine and those pursued by a conventional credit oriented agency or an investment institution. By definition, the venture capital investor focuses on opportunities with a high degree of innovation.

The deal flow composition and the technique of generating a deal flow can vary from country to country. In India, different venture capital funds/companies have their own methods varying from promotional seminars with R&D institutions and industry associations to direct advertising campaigns targeted at various segments. A clear pattern between the investment focus of a fund and the constitution of the deal generation network is discernible even in the Indian context.

Due Diligence

Due diligence is the industry jargon for all the activities that are associated with evaluating an investment proposal. It includes carrying out reference checks on the proposal related aspects such as management team, products, technology and market. The important feature to note is that venture capital due diligence focuses on the qualitative aspects of an investment opportunity.

It is also not unusual for venture capital fund/companies to set up an 'investment screen'. The screen is a set of qualitative (sometimes quantitative criteria such as revenue are also used) criteria that help venture capital funds/companies to quickly decide on whether an investment opportunity warrants further diligence. Screens can be sometimes elaborate and rigorous and sometimes specific and brief. The nature of screen criteria is also a function of investment focus of the firm at that point. Venture capital investors rely extensively on reference checks with 'leading lights' in the specific areas of concern being addressed in the due diligence.

A venture capitalist tries to maximize the upside potential of any project. He tries to structure his investment in such a manner that he can get the benefit of the upside potential ie he would like to exit at a time when he can get maximum return on his investment in the project. Hence his due diligence appraisal has to keep this fact in mind.

New Financing

Sometimes, companies may have experienced operational problems during their early stages of growth or due to bad management. These could result in losses or cash flow drains on the company. Sometimes financing from venture capital may end up being used to finance these losses. They avoid this through due diligence and scrutiny of the business plan.

Inter-Company Transactions

When investments are made in a company that is part of a group, inter-company transactions must be analyzed.

Investment Valuation

The investment valuation process is an exercise aimed at arriving at 'an acceptable price' for the deal. Typically in countries where free pricing regimes exist, the valuation process goes through the following steps:

- Evaluate future revenue and profitability
- Forecast likely future value of the firm based on experienced market capitalization or expected acquisition proceeds depending upon the anticipated exit from the investment.
- Target an ownership position in the investee firm so as to achieve desired appreciation on the proposed investment. The appreciation desired should yield a hurdle rate of return on a Discounted Cash Flow basis.
- Symbolically the valuation exercise may be represented as follows:

NPV = [(Cash)/(Post)] x [(PAT x PER)] x k, where

- NPV = Net Present Value of the cash flows relating to the investment comprising outflow by way of investment and inflows by way of interest/dividends (if any) and realization on exit. The rate of return used for discounting is the hurdle rate of return set by the venture capital investor.
- Post = Pre + Cash
- Cash represents the amount of cash being brought into the particular round of financing by the venture capital investor.
- 'Pre' is the pre-money valuation of the firm estimated by the investor. While technically it is measured by the intrinsic value of the firm at the time of raising capital. It is more often a matter of negotiation driven by the ownership of the company that the venture capital investor desires and the ownership that founders/management team is prepared to give away for the required amount of capital
- PAT is the forecast Profit after tax in a year and often agreed upon by the founders and the investors (as opposed to being 'arrived at' unilaterally). It would also be the net of preferred dividends, if any.
- PER is the Price-Earning multiple that could be expected of a comparable firm in the industry. It is not always possible to find such a 'comparable fit' in venture capital situations. That necessitates, therefore, a significant degree of judgement on the part of the venture capital to arrive at alternate PER scenarios.
- 'k' is the present value interest factor (corresponding to a discount rate 'r') for the investment horizon.

It is quite apparent that PER time PAT represents the value of the firm at that time and the complete expression really represents the investor's share of the value of the investee firm. The following example illustrates this framework:

Example: Best Mousetrap Limited (BML) has developed a prototype that needs to be commercialized. BML needs cash of Rs2mn to establish production facilities and set up a marketing program. BML expects the company will go public in the third year and have revenues of Rs70mn and a PAT margin of 10% on sales. Assume, for the sake of convenience that there would be no further addition to the equity capital of the company.

Prudent Fund Managers (PFM) propose to lead a syndicate of like minded investors with a hurdle rate of return of 75% (discounted) over a five year period based on BML's sales and profitability expectations. Firms with comparable sales and profitability and risk profiles trade at 12 times earnings on the stock exchange. The following would be the sequence of computations:

In order to get a 75% return p.a. the initial investment of Rs2 million must yield an accumulation of 2 x $(1.75)^5$ = Rs32.8mn on disinvestment in year 5.

BML's market capitalization in five years is likely to be Rs (70 x 0.1 x 12) million = Rs84mn.

Percentage ownership in BML that is required to yield the desired accumulation will be (32.8/84) x 100 = 39%

Therefore the post money valuation of BML At the time of raising capital will be equal to Rs(2/0.39) million = Rs5.1 million which implies that a pre-money valuation of Rs3.1 million for BML

Another popular variant of the above method is the First Chicago Method (FCM) developed by Stanley Golder, a leading professional venture capital manager. FCM

assumes three possible scenarios – 'success', 'sideways survival' and 'failure'. Outcomes under these three scenarios are probability weighted to arrive at an expected rate of return:

In reality the valuation of the firm is driven by a number of factors. The more significant among these are:

Overall economic conditions: A buoyant economy produces an optimistic long- term outlook for new products/services and therefore results in more liberal pre-money valuations.

- Demand and supply of capital: when there is a surplus of venture capital of venture capital chasing a relatively limited number of venture capital deals, valuations go up. This can result in unhealthy levels of low returns for venture capital investors.
- Specific rates of deals: such as the founder's/management team's track record, innovation/ unique selling propositions (USPs), the product/service size of the potential market, etc affects valuations in an obvious manner.
- The degree of popularity of the industry/technology in question also influences the pre-money. Computer Aided Skills Software Engineering (CASE) tools and Artificial Intelligence were one time darlings of the venture capital community that have now given place to biotech and retailing.
- The standing of the individual venture capital Well established venture capitals who are sought after by entrepreneurs for a number of reasons could get away with tighter valuations than their less known counterparts.
- Investor's considerations could vary significantly. A study by an American venture capital, VentureOne, revealed the following trend. Large corporations who invest for strategic advantages such as access to technologies, products or markets pay twice as much as a professional venture capital investor, for a given ownership position in a company but only half as much as investors in a public offering.
- Valuation offered on comparable deals around the time of investing in the deal.

Quite obviously, valuation is one of the most critical activities in the investment process. It would not be improper to say that the success for a fund will be determined by its ability to value/price the investments correctly.

Sometimes the valuation process is broadly based on thumb rule metrics such as multiple of revenue. Though such methods would appear rough and ready, they are often based on fairly well established industry averages of operating profitability and assets/capital turnover ratios

Such valuation as outlined above is possible only where complete freedom of pricing is available. In the Indian context, where until recently, the pricing of equity issues was heavily regulated, unfortunately valuation was heavily constrained.

Structuring A Deal

Structuring refers to putting together the financial aspects of the deal and negotiating with the entrepreneurs to accept a venture capital's proposal and finally closing the deal. To do a good job in structuring, one needs to be knowledgeable in areas of accounting, cash flow, finance, legal and taxation. Also the structure should take into consideration the various commercial issues (ie what the entrepreneur wants and what the venture capital would require to protect the investment). Documentation refers to the legal aspects of the paperwork in putting the deal together.

The instruments to be used in structuring deals are many and varied. The objective in selecting the instrument would be to maximize (or optimize) venture capital's returns/protection and yet satisfy the entrepreneur's requirements. The instruments could be as follows:

Instrument	Issues
Loan	clean vs secured
	Interest bearing vs non interest bearing
	convertible vs one with features (warrants)
	1st Charge, 2nd Charge,
	loan vs loan stock
	maturity
Preference shares	redeemable (conditions under Company Act)
	participating
	par value
	nominal shares
Warrants	exercise price, expiry period
Common shares	new or vendor shares
	par value
	partially-paid shares
Options	exercise price, expiry period, call, put

In India, straight equity and convertibles are popular and commonly used. Nowadays, warrants are issued as a tool to bring down pricing.

A variation that was first used by PACT and TDICI was "royalty on sales". Under this, the company was given a conditional loan. If the project was successful, the company had to pay a % age of sales as royalty and if it failed then the amount was written off.

In structuring a deal, it is important to listen to what the entrepreneur wants, but the venture capital comes up with his own solution. Even for the proposed investment amount, the venture capital decides whether or not the amount requested, is appropriate and consistent with the risk level of the investment. The risks should be analyzed, taking into consideration the stage at which the company is in and other factors relating to the project. (eg exit problems, etc).

Promoter Shares

As venture capital is to finance growth, venture capital investment should ideally be used for financing expansion projects (eg new plant, capital equipment, additional working capital). On the other hand, entrepreneurs may want to sell away part of their interests in order to lock-in a profit for their work in building up the company. In such a case, the structuring may include some vendor shares, with the bulk of financing going into buying new shares to finance growth.

Handling Director's And Shareholder's Loans

Frequently, a company has existing director's and shareholder's loans prior to inviting venture capitalists to invest. As the money from venture capital is put into the company to finance growth, it is preferable to structure the deal to require these loans to be repaid back to the shareholders/directors only upon IPOs/exits and at some

mutually agreed period (eg 1 or 2 years after investment). This will increase the financial commitment of the entrepreneur and the shareholders of the project.

A typical proposal may include a combination of several different instruments listed above. Under normal circumstances, entrepreneurs would prefer venture capitals to invest in equity as this would be the lowest risk option for the company. However from the venture capitals point of view, the safest instrument, but with the least return, would be a secured loan. Hence, ultimately, what you end up with would be some instruments in between which are sold to the entrepreneur.

Monitoring And Follow Up

The role of the venture capitalist does not stop after the investment is made in the project. The skills of the venture capitalist are most required once the investment is made. The venture capitalist gives ongoing advice to the promoters and monitors the project continuously.

It is to be understood that the providers of venture capital are not just financiers or subscribers to the equity of the project they fund. They function as a dual capacity, as a financial partner and strategic advisor. Venture capitalists monitor and evaluate projects regularly. They keep a hand on the pulse of the project. They are actively involved in the management of the of the investee unit and provide expert business counsel, to ensure its survival and growth. Deviations or causes of worry may alert them to potential problems and they can suggest remedial actions or measures to avoid these problems. As professional in this unique method of financing, they may have innovative solutions to maximize the chances of success of the project. After all, the ultimate aim of the venture capitalist is the same as that of the promoters – the long term profitability and viability of the investee company.

Exit

One of the most crucial issues is the exit from the investment. After all, the return to the venture capitalist can be realized only at the time of exit. Exit from the investment varies from the investment to investment and from venture capital to venture capital. There are several exit routes, buy-buck by the promoters, sale to another venture capitalist or sale at the time of Initial Public Offering, to name a few. In all cases specialists will work out the method of exit and decide on what is most profitable and suitable to both the venture capitalist and the investee unit and the promoters of the project.

At present many investments of venture capitalists in India remain on paper as they do not have any means of exit. Appropriate changes have to be made to the existing systems in order that venture capitalists find it easier to realize their investments after holding on to them for a certain period of time. This factor is even more critical to smaller and mid sized companies, which are unable to get listed on any stock exchange, as they do not meet the minimum requirements for such listings. Stock exchanges could consider how they could assist in this matter for listing of companies keeping in mind the requirement of the venture capital industry.

Accessing Venture Capital

Venture funds, both domestic and offshore, have been around in India for some years now. However it is only in the past 12 to 18 months, they have come into the limelight. The rejection ratio is very high, about 10 in 100 get beyond pre evaluation stage, and 1 gets funded.

Venture capital funds are broadly of two kinds - generalists or specialists. It is critical for the company to access the right type of fund, ie who can add value. This backing

is invaluable as focused/specialized funds open doors, assist in future rounds and help in strategy. Hence, it is important to choose the right venture capitalist.

The standard parameters used by venture capitalists are very similar to any investment decision. The only difference being exit. If one buys a listed security, one can exit at a price but with an unlisted security, exit becomes difficult. The key factors which they look for in

The Management

Most businesses are people driven, with success or failure depending on the performance of the team. It is important to distinguish the entrepreneur from the professional management team. The value of the idea, the vision, putting the team together, getting the funding in place are amongst others, some key aspects of the role of the entrepreneur. Venture capitalists will insist on a professional team coming in, including a CEO to execute the idea. One-man armies are passe. Integrity and commitment are attributes sought for. The venture capitalist can provide the strategic vision, but the team executes it. As a famous Silicon Valley saying goes "Success is execution, strategy is a dream".

The Idea

The idea and its potential for commercialization are critical. Venture funds look for a scalable model, at a country or a regional level. Otherwise the entire game would be reduced to a manpower or machine multiplication exercise. For example, it is very easy for Hindustan Lever to double sales of Liril - a soap without incremental capex, while Gujarat Ambuja needs to spend at least Rs4bn before it can increase sales by 1mn ton. Distinctive competitive advantages must exist in the form of scale, technology, brands, distribution, etc which will make it difficult for competition to enter.

Valuation

All investment decisions are sensitive to this. An old stock market saying "Every stock is a buy at a price and vice versa". Most deals fail because of valuation expectation mismatch. In India, while calculating returns, venture capital funds will take into account issues like rupee depreciation, political instability, which adds to the risk premia, thus suppressing valuations. Linked to valuation is the stake, which the fund takes. In India, entrepreneurs are still uncomfortable with the venture capital "taking control" in a seed stage project.

Exit

Without exit, gains cannot be booked. Exit may be in the form of a strategic sale or/and IPO. Taxation issues come up at the time. Any fund would discuss all exit options before closing a deal. Sometimes, the fund insists on a buy back clause to ensure an exit.

Portfolio Balancing

Most venture funds try and achieve portfolio balancing as they invest in different stages of the company life cycle. For example, a venture capital has invested in a portfolio of companies predominantly at seed stage, they will focus on expansion stage projects for future investments to balance the investment portfolio. This would enable them to have a phased exit.

In summary, venture capital funds go through a certain due diligence to finalize the deal. This includes evaluation of the management team, strategy, execution and commercialization plans. This is supplemented by legal and accounting due diligence, typically carried out by an external agency. In India, the entire process takes about 6

months. Entrepreneurs are advised to keep that in mind before looking to raise funds. The actual cash inflow might get delayed because of regulatory issues. It is interesting to note that in USA, at times angels write checks across the table.

Current Trends

Capital Is Pouring Into Private Equity Funds

The IPO boom and its exceptional returns to venture and other kinds of private equity investments have led institutional investors, pension funds and endowments to park their money in these investments.

Bigger Is Better

The most established venture funds now have more partners and therefore are able to put more money to work effectively. *Also*, venture firms are doing less deal syndication, which enables them to put more money to work in a single deal. *Thirdly*, many traditional early-stage venture firms have shifted to a multi-stage investment approach. They will back companies in technologies and industries they know intimately, almost *regardless* of the stage.

First-time Firms Never Had It So Good

During the 1989-91 downturn, new venture capital firms faced a problem in raising partnership capital, as there was a 'flight to quality' among investors who backed established funds in the private equity market. However, developments over the past few years have demonstrated that investing with an established firm is no more a sure-bet than an investment in a 'first-time fund'.

The State Wants Its Share Of The Pie Too

The Department of Electronics of the Government of India announced the creation of a Rs1bn IT fund. Many state governments are sponsoring the formation of new venture capital firms to spur the creation and growth of new business quickly followed this move. Andhra Pradesh, Karnataka, Kerala, Gujarat and West Bengal are among the states creating such programs. They are fairly controversial efforts, because they run the risk of sacrificing return for economic stimulus. Many would believe that they are not a good idea. However, some of them are better designed than others and few might actually work.

Venture Firms Are Being Run More Like Businesses

One of the healthiest consequences of the growth in institutional funding has been increased scrutiny that venture firms have come under. Feedback from previous investments and suggestions from the investors in these funds are helping to increase the sense of professionalism in the industry.

No More Men In Gray Suits

Another trend that is emerging slowly is the change in the profile of a fund manager. The venture capitalist is no longer a hybrid investment banker trying to cash in on another market boom while still keeping his cards close to his chest. The new-age venture capitalist is industry-bred and highly regarded in the business and is fairly at ease with the technologies and processes in the market.

Tomorrow Is Coming Faster

Rapid changes in technology have accelerated the pace and raised the efficiencies for getting from idea to market. *Investors are* specializing. Financing sources are becoming much more focused on their way to investment in today's competitive environment. Today, from venture capital firms to leveraged buyout (LBO) houses and corporations, investors are devising specific plans for industries and technologies they want to be in.

More Venture Funds Are Seeking Traditional Businesses

More venture capital funds are going after low-tech or no-tech companies. For example, Draper International has picked up a stake in Shoppers Stop and Indus League Clothing.

Financing Sources Are More Flexible

More companies are acquiring new ideas, products and complementary operations to capture growth and gain market share. This means financing must allow for covenants that permit mergers, acquisitions and continued investments.

Financing Sources And Companies Are Building Partnering Relationships

Companies need financing sources that allow them to move quickly and will tolerate risk, including acquisitions. Although financing sources are risking more, the rewards of such a partnering relationship can grow and be profitable for all concerned.

Competition Is Affecting Buyer Prices

Historically, there has been a big difference between strategic buyers who paid a premium for the potential of synergy and financial buyers and LBO houses. Today, the two factions are more directly competitive.

All businesses are not evaluated equally. Venture houses today are looking at what enhances the value of a company, with different 'value drivers' affecting various industry segments. For example, when evaluating a technology company, investors may care about a unique technology or process with great potential. They won't necessarily worry whether the company lacks audited financial statements or an organization structure. In a non-technology area, however, there must be more than a new idea; 'value drivers' might include historical performance, gross margins and return on investment.

Adapted from 'Growing Your Business' a publication of PwC Entrepreneurial Advisory Services.

Annexure: Summary Research Findings

In order to supplement the study on venture capital, India Infoline carried out a survey of some of the leading players in the venture capital environment today. As a part of the research, carried out in May and June 1999, 15 investing firms and intermediaries were interviewed about their expectations from the market and 30 promoters, CEOs or CFOs of IT companies were interviewed about their awareness of and perceptions about VC funding. The study was conducted in three cities – Mumbai, Pune and Bangalore.

The sample comprised of companies engaged in the IT segment – job contracting software development, offshore services, on-site development, systems and application software, hardware services and vendoring and training institutes.

A combination of judgement and convenience sampling was used and questionnaires were administered to the respondents after taking a prior telephonic appointment. The age-profile of the companies is included below.

Company Age Profile

Years	No. of companies
<1	7
1-3	6
3-5	9
5-10	6
>10	4

What Do Entrepreneurs Expect In A Venture Capital Investment?

Venture capital investors boast of bringing 'more than money' to the projects that they fund. This part of the study aimed at eliciting a response from the promoters of the projects about their expectations of a 'helping hand'. Listed below are the most common responses among the sample of IT investors and the percentage of people who agreed with them.

Expectation	Per cent
Assistance in terms of marketing advice, leads, networking	70%
Follow on/later stage financing	66%
Financial management and strategy	63%
Non executive governance	57%
Manpower planning, recruitment of personnel	47%
Doing away with legal hassles, red tape, bureaucracy	33%
Transfer of technology	20%

What Attributes Do Venture Capitalists Look For In A Deal?

Unlike the entrepreneurs, the VCs seem to be more in unison as they agree on a few critical success parameters. The respondents have identified the following critical factors.

Attribute	Per cent
Management quality	100%
Promoter's credentials and track record	86%
A focused development strategy	80%
A strong proprietary and competitive position	73%
A scalable business model	60%
An innovative concept, breakthrough technology	40%
Measurable milestones in the development strategy	27%

What Is The General Perception Of Venture Capital Investors In India?

Entrepreneurs were asked to comment on the current scenario of venture capital and private equity activity in India, with their perceptions regarding the problems/pitfalls associated.

Perception	Per cent
Insensitive to very early stage projects	53%
'Bankers' with little practical technical knowledge	47%
Invest only in successful expanding companies	40%
Negotiations take too long	40%
Do not meet our funding needs (less then $1 million)	27%
Making an approach, business plan is difficult	27%
Valuations are unfair	7%

Would You Consider/have You Considered Venture Capital Funding As A Source Of Capital For Your Project?

As pointed out earlier, a large number of these firms have been funded or are currently in the process of working out a deal with venture capital firms. Keeping this in mind, 93% of the respondents proved to be inclined towards venture capital. The alternative to venture capital, not surprisingly was the IPO route.

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LESSON 20
INSURANCE SERVICES: AN INTRODUCTION

Lesson Objectives: **To understand the Concept of Insurance,**
Its development in India and
Regulatory framework of insurance.

INTRODUCTION

Life is full of risks. Being a social animal and risk averse, man always tries to reduce risk. An age-old method of sharing of risk through economic cooperation led to the development of the concept of 'insurance'.

Insurance may be described as a social device to reduce or eliminate risk of loss to life and property. Insurance is a collective bearing of risk. Insurance spreads the risks and losses of few people among a large number of people, as people prefer small fixed liability instead of big uncertain and changing liability. Insurance is a scheme of economic cooperation by which members of the community share the unavoidable risks. The risks, which can be insured against include fire, the perils of sea, death, accidents, and burglary. The members of the community subscribe to a common pool or fund, which is collected by the insurer to indemnify the losses arising out of risks. Insurance cannot prevent the occurrence of risk but it provides for the losses of risk. It is a scheme, which covers large risks, by paying small amount of capital. Insurance is also a means of savings and investment.

Insurance can be defined as a legal contract between two parties whereby one party called insurer undertakes to pay a fixed amount of money on the happening of a particular event, which may be certain or uncertain. The other party called insured pays in exchange a fixed sum known as premium. The insurer and the insured are also known as Assurer, or Underwriter, and Assured, respectively. The document, which embodies the contract, is called the policy.

An insurance contract is based on some basic principles of insurance.

(a) Principle of 'Uberrima Fides' or Principle of utmost good faith.
(b) Principle of Indemnity.
(c) Doctrine of Subrogation.
(d) Principle of Causa Proxima.
(e) Principle of insurable interest.

(a) Principle of utmost good faith: It means "maximum truth". All material information regarding the subject matter of insurance should be disclosed by both

the parties-the insurer and the insured. This duty of full disclosure rests more heavily on the insured than the insurer. The insurer has a right to avoid the contract if the insured fails to make the full disclosure.

(b) Principle of indemnity: This means that if the insured suffers a loss against which the policy has been made, he shall be fully indemnified only to the extent ofloss. In other words, the insured is not entitled to make a profit on his loss.

(c) Doctrine of subrogation: This means the insurer has the right to stand in the place of the insured after settlement of claims in so far as the insured's right of recovery from an alternative source is involved. The right may be exercised by the insurer before the settlement of the claim. In other words, the insurer is entitled to recover from a negligent third party any loss payments made to the insured. The purposes of subrogation are to hold the negligent person responsible for the loss and prevent the insured from collecting twice for the same loss.

(d) Principle of *causa proxima:* The cause of loss must be direct and an insured one in order to claim for compensation.

(e) Principle of insurable interest: The assured must have insurable interest in the life or property insured. Insurable interest is that interest which considerably alters the position of the assured in the event of loss taking place and if the event does not take place, he remains in the same old position. One who has to lose as a result of loss may be said to have insurable interest in the life or property insured. If this principle is absent, the insurance contract degenerates into a wagering contract. It is taken as given that an individual has insurable interest in his/her own life or property. Cases where no proof of insurable interest is required are that of a husband's interest in his wife's life and wife's interest in her husband's life. In cases of business and family relationships, proof of insurable interest is required.

ORIGIN AND DEVELOPMENT OF INSURANCE

The concept of insurance is believed to have emerged almost 4,500 years ago in the ancient land of Babylonia where traders used to bear risk of the caravan by giving loans, which were later repaid with interest when the goods arrived safely. In order to protect against the risk of loss of goods in transit, piracy and natural calamities like storms and so on, medieval guilds (trade associations) formed a common pool of funds, which was used as support in times of sickness and death and sometimes even offered as ransom for members held captive by pirates. The first insurance contract was entered into by European maritime nations in 1347 to accept marine insurance as a practice.

The concept of insurance as we know today took shape in 1688 at a place called Lloyd's Coffee House in London where risk bearers used to meet to transact business. This coffee house became so popular that Lloyd's became the one of the first modem insurance companies by the end of the eighteenth century.

Marine insurance companies came into existence by the end of the eighteenth century. These companies were empowered to write fire and life insurance as well as marine. The Great Fire of London in 1966 caused huge loss of property and life. With a view to providing fire insurance facilities, Dr. Nicholas Barbon set up in1967 the first fire insurance company known as the Fire office.

The oldest life insurance company in existence today is the Society for the Equitable Assurance of Lives and Survivorship, known as 'Old Equitable'. It was established in England in 1756.

The mortality tables were constructed in the seventeenth century. The first mortality table was constructed by an astronomer Edmund Haley in 1693. This table provided a link between the life insurance premium and average life spans based on statistical laws of mortality and compound interest. In 1756, Joseph Dodson reworked the table, linking insurance premium rate to age.

The infamous New York Fire and the great Chicago Fire in 1835 and 1871, respectively, created an awareness and need for insurance. The concept of reinsurance emerged to deal specifically for such situations. Industrialisation and urbanisation popularised the concept of insurance and growth in insurance led to the development of new insurance products.

History of Insurance in India

The early history of insurance in India can be traced back to the Vedas. The Sanskrit term 'Yogakshema' (meaning well being), the name of Life Insurance Corporation of India's corporate headquarters, is found in the Rig Veda. Some form of 'community insurance' was practiced by the Aryans around 1000 BC. The joint family system prevalent in India was an important form of social cooperation.

Life insurance in its modem form came to India from England in 1818. The Oriental Life Insurance Company was the first insurance company to be set up in India to help the widows of European community. The insurance companies, which came into existence between 1818 and 1869, treated Indian lives as subnormal and charged an extra premium of 15 to 20 per cent. The first Indian insurance company, the Bombay Mutual Life Assurance Society, came into existence in 1870 to cover Indian lives at normal rates. Moreover, in 1870, the British Government enacted for the first time the Insurance Act, 1570. Other companies, such as the Oriental Government Security Life Assurance Company, the Bharat Insurance Company, and the Empire of India Life Insurance Company Limited, were set up between 1870 and 1900.

The Swadeshi movement of 1905-07, the non-cooperation movement of 1919, and Civil Disobedience Movement of 1929 led to an increase in number of insurance companies. In 1912, the first legislation regulating insurance, the Life Insurance Companies Act, 1912, was promulgated. The growth of life insurance was witnessed during the first two decades of the twentieth century not only in terms of number of companies but also in terms of number of policies and sum assured. Indian Insurance Year Book was published for the first time in 1914.

The Insurance Act, 1938, the first comprehensive legislation governing both life and non-life branches of insurance was enacted to provide strict state control over insurance business. This amended insurance Act looked into investments, expenditure, and management of these companies. An office of the Controller of Insurance came into existence. The Controller of Insurance had wide-ranging powers, which included directing, cautioning, advising, prohibiting, inspecting, investigating,

searching, seizing, prosecuting, penalising, authorising, registering, amalgamating, and liquidating insurance companies.

By the mid-1950s, there were 154 Indian insurers, 16 foreign insurers, and 75 provident societies carrying on life insurance business in India. Insurance business flourished and so did scams, irregularities, and dubious investment practices by scores of companies. As a result, the government decided to nationalise the life assurance business in India. The Life Insurance Corporation of India (LIC) was set up in 1956 to take over 245 life companies. The nationalisation of life insurance was followed by general insurance in 1972. The General Insurance Corporation of India and its subsidiaries were set up in 1973. Most of the powers of the Controller of Insurance were taken away and vested in state-owned LIC and GIC for operational convenience. These nationalised companies enjoyed monopoly for decades. They did a commendable job in extending the distribution network and successfully handled a large volume of business. But with only 20 per cent of the population insured there was a vast potential untapped. Besides, as a sequel to the reform process and to tap the insurance sector as a source of long-term funds, the government decided to introduce reforms in the insurance sector.

The Government set up, in 1993, a committee under the chairmanship of R N Malhotra, the former insurance secretary and RBI governor to evaluate the Indian insurance industry and recommend its future direction. This committee submitted its report in 1994 and suggested the re-opening up of the insurance sector to private players. This sector was finally thrown open to the private sector in 2000. The Insurance Regulatory and Development Authority (IRDA) was set up in 2000 as an autonomous insurance regulator. The government has entrusted IRDA with the responsibility for carrying out the reforms in this sector.

OPENING UP OF THE INSURANCE SECTOR

The insurance industry till the nineties had only two nationalised players: Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) and its four subsidiaries. These two players had a monopolistic control over the market. These nationalised insurance companies did a commendable job in terms of high growth in volume of business and reach. However, they were not consumer oriented, unwilling to adopt modem practices and technology to upgrade technical skills, and inefficient in operations. The growth in volume was mainly driven by income-tax considerations and hence a major portion of the vast rural area was untapped.

Moreover, with a population of more than one billion and savings rate of around 24 per cent, India has a vast market, which is untapped. The foreign insurance companies' external influence and pressure to open up the Indian insurance sector was high.

In 1993, the committee under the chairmanship of R N Malhotra, set up to evaluate the Indian Insurance industry and recommend its future direction, submitted its report in 1994 and its major recommendations revolved around the structure and regulation of insurance industry. The main recommendations were:

(i) The government should bring down its stake in the insurance companies to 50 per cent.

(ii) Private companies with a minimum paid-up capital of Rs 100 crore should be allowed to enter the industry.

(iii) No single company should be allowed to transact business both life and general insurance business. The number of entrants should be controlled.

(iv) Foreign companies may be allowed to enter the industry in collaboration with the domestic companies. The committee did not favor foreign companies operating in India through branches.

(v) Postal Life Insurance should be allowed to operate in the rural markets.

(vi) The mandatory investments of LIC Life Fund in government securities need to be reduced from 75 per cent to 50 per cent.

(vii) The GIC and its subsidiaries should not hold more than 5 per cent in any company.

(viii) The promoters' holding in a private insurance company should not exceed 40 per cent of the total. However, if the promoters wish to start with a higher holding, they should be permitted to do so provided their holding is brought down to 40 per cent within a specified period of time through public offering. No person other than the promoters should be allowed to hold more than one per cent of the equity. Promoters should at no time hold less than 26 per cent of the paid-up capital.

(ix) Regulatory and prudential norms as well as conditions for ensuring level-playing field among insurers should be finalised early so that intending entrants into the insurance business would be aware of the stipulations they would have to comply with. These conditions should aim to ensure that life insurers do not neglect the small man or the rural business and that the general insurers have balanced portfolios.

(x) Though nationalised insurance companies are in a position to face competition, it is essential that they quickly upgrade their technology, reorganise themselves on more efficient lines, and are enabled to operate as board-run enterprises.

(xi) As an interim measure, the office of Controller of Insurance should be restored its full functions under the Insurance Act and it should be set up as a separate office as a matter of high priority.

(xii) Legislation and government notifications through which LIC and GIC were exempted from several provisions of the Insurance Act should be withdrawn.

(xiii) A strong and effective insurance regulatory authority in the form of a statutory autonomous board on the lines of SEBI should be set up.

(xiv) The state level cooperatives should be allowed to set up cooperative societies for transacting life insurance business in the state. There will not be more than one society for each state which will be subject to the regulations of Insurance Regulatory Authority.

(xv) GIC should cease to be the holding company for its subsidiaries and the exclusive function of GIC should remain that of reinsurer.

(xvi) When GIC ceases to be holding company of the four subsidiary companies, then the government should acquire GIC's stake, which is Rs 40 crore in every company. This share, then should be raised to Rs 100

crore for every company, the government holding 50 per cent and the rest being held by the public at large.

Recognising the global trend of competitive, market driven, insurance industry and the recommendations of the Malhotra Committee, the insurance industry was opened up in August 2000. There are at present 12 life insurance and 11 general insurance companies operating in India with more players expected to come in. The Insurance Regulatory and Development Authority (IRDA), constituted in April 2000 under the IRDA Act, 1999, is vested with the power to regulate and develop the insurance and reinsurance business.

Most of the foreign insurers have preferred to form joint ventures with Indian companies. Banks, financial institutions, and non-banking finance companies are permitted to enter the insurance sector. The Reserve Bank has issued guidelines regulating the degree of participation of banks, financial institutions and non-banking finance companies in the insurance business depending on balance sheet strength. The Reserve Bank accorded approval to five banks for joint ventures on risk participation basis while 18 banks and a subsidiary of a bank were given 'in principle' approval for agency business. The Reserve Bank has given permission to

(a) five NBFCs to undertake insurance business as joint venture participants
(b) one NBFC to engage in insurance agency business as well as to make strategic investment in equity of an insurance company
(c) two NBFCs to make only strategic investments
(d) two NBFCs to undertake only insurance agency business.

The Insurance (Amendment) Act, 2002, has allowed cooperative societies to carry on insurance business with a view to enhancing coverage in rural areas. This Act deals in four broad areas, namely, broken regulation, corporate agent regulations, section 64VB that deals in payments to be made through credit card and internet, and section 49 that deals with the distribution of actuarial surpluses between the shareholder and policyholder. Corporate acting as corporate agents will have to surrender their licence to be brokers, as there is a conflict of interest between two parties. Banks will continue to be corporate agents and non-brokers. The designated person, acting on behalf of the corporate agent (like a bank) after leaving their jobs can be an agent without having to take further exams mandated by the regulator. The amended insurance act would form the future legal base for making the regulation on intermediaries.

INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY

The Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the business of insurance and re-insurance in India. The Authority was constituted on April 19, 2000, vide Government of India's notification No. 277.

The Insurance Regulatory and Development Authority Act, 1999, was enacted by Parliament in the fiftieth year of the Republic of India to provide for the

establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry, and for matters connected therewith or incidental thereto and further to amend the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972. The Act was approved in the Parliament in December 1999 and the insurance sector was thrown open for private licensees on August 15, 2000. IRDA was constituted in terms of the Insurance Regulatory and Development Authority Act, 1999, as the regulator of the Indian Insurance industry.

IRDA was set up in 1996 but it was formally constituted as a regulator of the insurance industry in April 2000. The regulator was initially known as the Insurance Regulatory Authority but was subsequently rechristened as Insurance Regulatory and Development Authority as it was provided that it had a broader role to perform in the Indian insurance market. It has not only to frame and issue statutory and regulatory stipulations, guidelines, and clarification but it has also to perform a developmental and promotional role. The developmental and promotional role of the regulator include facilitating the growth of the market by attracting large number of players, integrating of the insurance market with the domestic financial services market, and synchronising the Indian Insurance market with that of global insurance market. Thus, the objectives of IRDA are two fold: policyholder protection and healthy growth of the insurance market.

Key Market Indicators

Size of Market, Life and Non-Life	$8 Billion a year @			
Rate of Annual Growth	Average of 20% for Life and 12% for Non-Life (1990-99)			
Geographical Restriction for New Players	None. Players can operate all over the country.			
Equity Restriction in a New Indian Insurance Company	Foreign promoter can hold upto 26%.			
Registration Restriction	Composite Registration not available.			
Market Opening	August 2000 with invitation for application for registration.			
Number of Registered Companies	Type of Business	Public Sector	Private Sector	Total
	Life Insurance General Insurance Reinsurance	01 04 01	12 09 0	13 13 01
	Total	06	21	27
New Registration Awarded	Twenty-one New Registrations issued:			
	Life Insurance			
	1. Allianz Bajaj Life Insurance Company Limited. 2. *Birla Sun-Life Insurance Company Limited. 3. *HDFC Standard Life Insurance Company Limited.			

	4. *ICICI Prudential Life Insurance Company Limited. 5. ING Vysya Life Insurance Company Limited. 6. *Max New York Life Insurance Company Limited. 7. Metlife Insurance Company Limited. 8. Om Kotak Mahindra Life Insurance Company Ltd. 9. *SBI Life Insurance Company Limited. 10. *TATA AIG Life Insurance Company Limited. 11. AMP SAN MAR Insurance Company Limited. 12. Dabur CGU Life Insurance Company Private Ltd.
	General Insurance
	1. Bajaj Allianz General Insurance Company Limited. 2. ICICI Lombard General Insurance Company Ltd. 3. *IFFCO-Tokio General Insurance Company Ltd. 4. *Reliance General Insurance Company Limited. 5. *Royal Sundaram Alliance Insurance Company Ltd. 6. *TATA AIG General Insurance Company Limited. 7. Cholamandalam General Insurance Company Ltd. 8. Export Credit Guarantee Corporation Limited. 9. HDFC-Chubb General Insurance Company Limited.
Business of New Players	Expected to take up a market share of 4-5% in three years.

* Insurers registered in 2000-01, others have been registered subsequently. Source: IRDA, Annual Report, 2000-01.

IRDA has a Chairman and four whole-time and four part-time members. IRDA has constituted the insurance Advisory Committee and in consultation with this committee has brought out seventeen regulations. A leading consumer activist has also been inducted into the Insurance Advisory Committee. In addition, representatives of consumers, industry, insurance agents, women's organisations, and other interest groups are a part of this committee. It has also formed a Consumer Advisory Committee and a Surveyor and Loss Assessors Committee. It has a panel of eligible Chartered Accountants to carry out investigation, inspection, and so on.

IRDA has till 2001 issued seventeen regulations in the areas of registration of insurers, their conduct of business, solvency margins, conduct of reinsurance business, licensing, and code of conduct intermediaries. It follows the practice of prior consultation and discussion with various interest groups before issuing regulations and guidelines.'"

Mission Statement of IRDA

- To protect the interest of and secure fair treatment to policyholders.
- To bring about speedy and orderly growth of' the insurance industry (including annuity and super-annuation payments) for the benefit of the common man, and to provide long-term funds for accelerating growth of the economy.
- To set, promote, monitor, and enforce high standards of integrity, financial soundness, fair dealing, and competence of those it regulates.

- To ensure that insurance customers receive precise, clear, and correct information about products and services and make them aware of their responsibilities and duties in this regard.
- To ensure speedy settlement of genuine claims, to prevent insurance frauds, and other malpractices and put in place effective grievance redressal machinery.
- To promote fairness, transparency, and orderly conduct in financial markets dealing with insurance and to build a reliable management information system to enforce high standards of financial soundness amongst market players.
- To take action where such standards are inadequate or ineffectively enforced.
- To bring about optimum amount of self-regulation in day-to-day working of the industry, consistent with the requirements of prudential regulation.

Duties, Powers and Functions of IRDA

Section 14 of IRDA Act, 1999, lays down the duties, powers, and functions of IRDA. Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote, and ensure orderly growth of the insurance business and re-insurance business. Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the authority shall include:

(a) Issuing to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration.
(b) Protection of the interests of the policy-holders in matters concerning assigning of policy, nomination by policy holders, insurable-interest, settlement of insurance claim, surrender value of policy, and other terms and conditions of contracts of insurance.
(c) Specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents.
(d) Specifying the code of conduct for surveyors and loss assessors.
(e) Promoting efficiency in the conduct of insurance business.
(f) Promoting and regulating professional organisations connected with the insurance and re-insurance business.
(g) Levying fees and other charges for carrying out the purposes of this Act.
(h) Calling for information from, undertaking inspection of, conducting inquiries and investigations, including audit of the insurers, intermediaries, insurance intermediaries, and other organisations connected with the insurance business.
(i) Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938).
(j) Specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries.
(k) Regulating investment of funds by insurance companies.
(l) Regulating maintenance of margin of solvency.

(m) Adjudication of disputes between insurers and intermediaries or insurance intermediaries.
(n) Supervising the functioning of the Tariff Advisory Committee.
(o) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f).
(p) Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and exercising such other powers as may be prescribed.

LESSON 21
INSURANCE SERVICES: REGULATORY FRAMEWORK - I

Lesson Objectives: **To understand the regulatory requirements of the insurance sector and role of IRDA in it.**

To understand about the Reinsurance business and regulations related to it.

Dear students, in last session we discussed about the origin of insurance, its position in India and had an introduction of IRDA. In today's session we are going to understand about the regulatory framework related to insurance sector. Since there are various rules and regulations, our discussion will continue for next two sessions in this regard.

Operations of IRDA

1. IRDA has developed its internal parameters to assess the promoters' credentials. The promoters' long term commitment to stay in the market, their ability to bring in new techniques in insurance underwriting and administration are some of the parameters, which are assessed in the first phase. Subsequent to this preliminary assessment, IRDA conducts an in-depth assessment of the business plans submitted by the promoter.
   IRDA is the sole authority for awarding licenses. There is no restriction in the number of licenses it can issue, but licenses for life and non-life business are to be issued separately. Licenses are issued only on a national basis. The new players should commence business within 15-18 months of getting the license. A new applicant has to pay a registration fee of Rs 50,000. At the time of renewal of registration every year, a fee of 0.20 per cent of 1 per cent of the gross premium or Rs 50,000 whichever is higher, is levied on the insurers carrying out insurance business in India.
   IRDA has prescribed a 'file and use' procedure, according to which every insurer is required to file the product and pricing details alongwith copies of standard terms, conditions, and literature. In case of tariff products, the Tariff Advisory Committee is required to file product and pricing details with IRDA, like any other insurance company.
2. All insurance intermediaries, such as agents and corporate agents, have to undergo compulsory training prior to their obtaining a license. IRDA also specified the minimum educational qualifications for these intermediaries. IRDA conducts examinations and then issues licenses to these agents. IRDA believes that a well trained and informed intermediaries can service the consumers better. IRDA insured or renewed 1,18,154 agents licenses by the end of March 2001. The licensing of Insurance Agents Regulations have specified the qualifications for an insurance agent: hundred hours pre-licensing training, followed by an examination. In addition, for new agents 25 hours training to keep knowledge updated has also been prescribed at the time of renewal of license

3. The Insurance Association and Life Insurance and General Insurance Councils have been revived and they are responsible for setting the norms for market conduct, ethical behaviour of the insurers, and breach of regulations. Continuous training has been stipulated to enhance the efficiency of the intermediaries. New players have set up call centres which are functioning on 24/7 basis.
4. IRDA has recognised the Actuarial Society of India and Insurance Institute of India as nodal organisations responsible for actuarial and insurance education. IRD A has drafted separate bills of the Actuarial Society of India and the Institute of Surveyors and Loss Assessors in order to grant them statutory status.
5. IRDA has also entered into an MOD with the Indian Institute of Management, Bangalore, to further its objective of insurance research and education. It has set up a risk management resource centre in Bangalore.
6. IRDA has come out with the Insurance Advertisement and Disclosure Regulations to ensure that the insurance companies adhere to fair trade practices and transparent disclosure norms while addressing the policy holders or the prospects.

Specified Percentage of Business to be done by an Insurer in the Rural Sector

In order to spread insurance to rural areas, IRDA has made it mandatory for every insurer to undertake business in social and rural sectors.

Every insurer, who carries an insurance business after the commencement of the IRDA Act, 1999, is required to ensure that the following obligations are undertaken during the first five financial years, in respect of the following:

(a) Rural Sector (where the population is not more than 5,000, population density not more than 400 per sq km, and at least 75 per cent of male working population is engaged in agriculture).
   (i) In respect of a life insurer:
      - 5 per cent in the first financial year.
      - 7 per cent in the second financial year.
      - 10 per cent in the third financial year.
      - 12 per cent in the fourth financial year.
      - 15 per cent in the fifth financial year of total policies written direct in that year.
   (ii) In respect of a general insurer:
      - 2 per cent in the first financial year.
      - 3 per cent in the second financial year.
      - 5 per cent thereafter, of total gross premium income written direct in that year.
(b) Social Sector (includes unorganized-sector, informal sector, economically vulnerable or backward classes, and other categories of persons, both rural and urban areas) in respect of all insurers.
      - 5,000 lives in the first financial year.
      - 7,500 lives in the second financial year.
      - 10,000 lives in the third financial year.
      - 15,000 lives in the fourth financial year.
      - 20,000 lives in the fifth year.

In the case of government insurers, the quantum of insurance business to be done shall not be less than what has been recorded by them for the accounting year ended March 31, 2000.

IRDA relaxed stringent rural sector obligations in September 2002. It removed the strict rural sector definition that was acting as an impediment for new private sector insurance companies to meet their compulsory rural sector obligations. With this, the insurance companies will be allowed to follow the census of India style for identifying and tapping the rural business market. Henceforth, anything that is not urban will be rural.

	Population (in crore)		Percentage of
Census Year	Rural	Total	Rural to Total
1961	36.0	43.9	82.0
1971	43.9	54.8	80.1
1981	52.4	68.3	76.6
1991	62.9	84.6	74.3
1991 *	37.7	84.6	44.5

** As per IRDA. Source: The Economic Times, September 27,2002, p. 8.*

Maintenance of Books of Accounts

The insurance companies and intermediaries are required to maintain their books of accounts and submit returns to IRDA as per the regulations prescribed in:

1. Preparation of Financial Statements and Auditor's Report of Insurance Companies Regulation, 2000.
2. Acturial Report and Abstract Regulations, 2000.
3. Assets, Liabilities and Solvency Margin of Insurers Regulations, 2000.
4. Insurance Surveyors and Loss Assessors (Licensing, Professional Requirements and Cede of Conduct) Regulations, 2000.
5. Investment Regulations, 2000 and Investment (Amendment) Regulations, 2001.

The public sector insurers have to switch to new regulations and requirements within a period of two years from the notification of these regulations.

Insurance Policyholders' Protection

In order to protect the interests of policyholders and build up their confidence in insurers, the institution of ombudsman has been set up. The Insurance Council is the administrative body of this institution and it has appointed 12 ombudsmen across the country. The insurance ombudsman is empowered to receive and consider written complaints in respect of insurance contracts on personal lines where the insured amount is less than Rs 20 lakh. The complaint can relate to:

(a) Grievance against insurer.
(b) Partial or total repudiation of claims by the insurer.
(c) Dispute in regard to premium paid or payable in terms of the policy.
(d) Dispute on the legal construction of the policy in so far as such dispute relate to claims.
(e) Delay in settlement of claims.

(f) Non-issue of any insurance document to customers after receipt of premium.

An ombudsman is entrusted with two functions—conciliation and award making. The awards passed by an ombudsman are binding on insurers and they are required to honor the awards within three months. The Insurance Ombudsman Scheme is complementary to the regulatory functions of IRDA.

IRDA has also proposed to set up two separate policy holder protection funds for general and life insurers. The insurers have been asked to contribute one per cent of their profits to the fund.

Exposure/Prudential Norms

IRDA has specified the exposure/prudential norms relating to investment. Every insurer shall limit his investments based on the following exposure norms:

A. Exposure Norms

Type of Investment	Limit for Investee Company	Limit for the Entire Group to which the Investee Company Belongs	Limit for the Industry Sector to which the Investee Company Belongs
(a) Equity/Preference Shares / Convertible portion of Debentures at face value.	(1) As on any date- not exceeding 20% of the total capital employed:	(1) As on any date: Not exceeding 15% of the total capital employed* of the group companies.	
(b) Debentures- (face value) including privately placed non-convertible debentures (NCDs) and non-convertible portion of convertible debentures			Not exceeding 15% of the total capital employed* in all such companies.
(c) Short-/Medium-/ Long-term Loans any other direct financial Assistance	(2) During the year- Not exceeding 5% of annual accretion of funds.	(2) During the year- not exceeding 10% of estimated annual accretion of funds.	

* Total capital employed means total of equity shares, preference shares, debentures, long-/medium-/shortterm loans (excluding public deposits), free reserves but excluding revaluation reserves of the investee company, as shown in its last audited balance sheet.

B. Exposure Norms for Investment in Public Financial Institutions

Equity shares and Preference shares (at their face value).	Not exceeding 15% in general of the paid-up equity/ preference capital of the institution or the existing holding level, if higher.

Investment in Equity Capital, Bonds, Debentures, Term Loans.	Not exceeding 10% of the capital employed by an institution as per the last audited balance sheet.
Total Investment vis-a-vis Net Worth of the company.	Not exceeding 60% of the net worth of the institution.
Total Investment in a financial year.	75% of annual accretions.
Total Investments in all the Financial Institutions.	Annual aggregate financial assistance to all Development Financial Institutions put together in a single year shall not exceed 20% of the estimated annual accretions for the year.

Note: Accretion of funds means investment income, gains on sale/redemption of existing investment and operating surplus.

C. Prudential Norms

The prudential norms for various instruments shall be as under:

Debentures: Norms for fully convertible debentures and partially convertible debentures: Investment decisions are related to attractiveness of equity shares to be received as a result of conversion.

Due consideration is also given to the factors, namely, rate of interest at the time of subscription to said debentures, appreciation, and dividend income to be received from the equity shares.

Similar considerations also apply for non-convertible debentures (NCDs) with detachable warrants attached to it.

Norms for non-convertible debentures and non-convertible debentures with warrants attached:

(a) Working Capital Debentures: 20 per cent of the current assets, loans and advance minus outstanding amount of existing working capital non-convertible debentures.

(b) Project Finance: As appraised by the Investment Committee.

(c) Normal Capital Expenditure: As assessed by the Investment Committee.

Asset cover (as specified in Schedule Ill): First *paripassu* charge on fixed assets of the company offered as security with a minimum of 1.25 times including proposed borrowings (excluding revaluation of assets).

Debt-Equity Ratio (as specified in Schedule ill). Not to exceed 2: I including the proposed non-convertible debenture issue. However, in case of capital-intensive project debentures, higher ratio up to 4:1 may be considered.

Interest cover (as specified in Schedule III): Not less than 2 times for the latest year or on the basis of the average of the immediately preceding three years after including the interest on the proposed debentures at the applicable rate.

Dividend payout: Minimum dividend of 10 per cent in each of the two years out of the immediately preceding three years including the latest year.

Term Deposits and Loans with Non-Banking Companies

The insurer needs to place the deposits with a view to catering to working capital needs of the corporate sector. The placement of the deposit is to be decided after evaluating financial and non-financial assets of the performance parameters of the companies. The analysis needs to include study of financial position, track record, and

other features such as quality of management, future prospects and market potential for the company's products. Credit rating of turnover should be uniformly maintained at a position which is indicative of a very strong financial position being not less than AA of Standard and Poor or equivalent rating of any other reputed and independent rating aging.

The maximum amount of short-term deposit that may be placed with any company is restricted to Rs 2 crore or 10 per cent of net worth whichever is less.

The various norms/parameters for the placement of term loans are as under:

Particulars	Limits
Unsecured borrowing as a Percentage of net worth	Not to exceed 25 per cent of net worth, including the proposed loan, subject to net worth of the borrowing company being not less than Rs 15 crore.
Interest cover	At least 2.5 times, including interest on proposed loans.
Debt/Equity Ratio	Not to exceed 2:1.
Current Ratio	Not less than 1.33:1.
Dividend Record	At least 10 per cent for the last 5 years or 15 per cent and above for 3 out of
	5 years.
Listing on an	Equity Shares of the company shall be listed on any recognised stock Exchange and the price should continuously be quoting above par at least for 12 months prior to the date of sanction of loan.
Collateral security	Cheques shall be obtained for principal and interest amount. Personal Guarantee of promoters and pledge of shares may be taken.

Infrastructure and Social Sector

In the case of projects/works in the infrastructure and social sector undertaken by a person other than a company, the norms indicated in the table above shall have to be met to the extent applicable.

Guidelines on Subscription to Preference Shares They are:

(a) Companies whose preference shares are selected for investment should have sound financial position and steady income earning capacity.
(b) The dividend payable on the preference shares should be cumulative.
(c) The preference shares shall be redeemable.
(d) Preference capital after proposed issue shall not exceed 100 per cent of equity capital.
(e) Dividend should have been paid on equity shares for two years out of immediately preceding three years.
(f) Preference dividend should have been paid for 3 years or 3 out of 4 or 5 years, including latest 2 years if the preference shares are issued earlier.
(g) Non-dividend paying preference shares should not be considered for investment.
(h) Dividend cover on the basis of average profit of last 3 to 5 years should be 3 times.

Returns to be Submitted by the Insurer:

Every insurer shall submit to IRDA the following returns within such time, at such intervals and verified/certified in such manner as indicated there against. These returns shall be in addition to those prescribed in Insurance Rules, 1999.

Form No. as /Annexed to These Regulations	Short Description	Periodicity of Returns	Time limit for Submission	Verified/ Certified by
Form 1	Statement of Investment and income on investment	Yearly	Within 30 days from the date of Board approval of audited accounts	Principal Officer/Chief (Investment)
Form 2	Statement of Downgraded Investments	Quarterly	Within 21 days of the end of each quarter	Principal Officer/Chief (Investment)
Form 3A	Statement of Investment of Controlled Fund (Life)-Compliance Report	Quarterly	Within 21 days of the end of each quarter	Principal Officer/ Chief (Investments)
Form 3B	Statement of Investment of Total Assets (General)-Compliance Report	Quarterly	Within 21 days of the end of each quarter	Principal officer/ Chief (Investment)
Form 4	Prudential Investment Norms-Compliance Report	Yearly	Within 30 days from the date of Board approval of audited accounts	Principal Officer/ Chief (Investment)

IRDA may, by any general or special orders, modify or relax any requirement relating to the above. 'Principal Officer' means any person connected with the management of an insurer or any other person upon whom the Authority has served notice of its intention of treating him as the principal officer thereof.

Constitution of Investment Committee

Every insurer shall constitute an Investment Committee which shall consist of a minimum of two non-executive directors of the Insurer, the Principal Officer, Chiefs of Finance and Investment divisions, and wherever an appointed actuary is present, the Appointed Actuary. The decisions taken by the Investment Committee shall be properly recorded and be open to inspection by the Officers of the Authority.

International Presence of IRDA

IRDA is a member of the International Association of Insurance Supervisors, (IAIS) headquartered at Basel, Switzerland. The IAIS is an organisation set up by regulators and supervisors of insurance industry. The aims and objectives of the IAlS are to bring in prudential regulations, to prescribe guidelines for the insurance

supervisors to observe the industry, to promote international co-operation and understanding among the supervisors, and to represent before world forums the cause of the insurance industry ailed the matter of its functioning and regulation. IRDA is a member of the Emerging Markets and Technical Committees. Its Chairman is also a member of the Accounting Sub-Committee and the Insurance Frauds Committee. IRDA is putting in efforts to bring the Indian insurance market to international standards in areas of financial viability, competence, technology and prudential regulations.

HEALTH INSURANCE

There are three types of insurance-general, life, and health. In India, no company offers health insurance as a stand-alone product. Even after the opening up of the insurance sector there were no applications of companies to set up an exclusive health insurance business. The major impediment is the requirement of a minimum working capital of Rs 100 crore, which is considered to be too large for a stand-alone health insurance business.

Health Insurance, or Health cover, is defined in the Registration of Indian Insurance Companies Regulations, 2000, as the effecting of contracts which provide sickness benefits or medical, surgical, or hospital expense benefits, whether in-patient or out-patient, on an indemnity, reimbursement, service, prepaid, hospital or other plans basis, including assured benefits and long-term care.

IRDA has encouraged both life and general insurance companies, old and new, to go in for rider policies offering health covers. Many new companies have gone in for riders offering a variety of health products. Riders are add-on benefits attached to the main life policy. To attract players to health insurance, life insurance companies will have no cap on health riders. While the relaxation has been given on the health riders, the 30 per cent cap on the premium of the base policy continues for other riders.

Third Party administrators (TPAs) are distributors of insurance products in the health insurance sector. They facilitate the smooth operation of a health cover by acting as a link between the insurance companies and their clients and hospitals. IRDAhas set up the minimum cap of Rs 1 crore for TPAs. The Rs 300 crore health insurance sector is expected to jump to Rs 1,500 crore by 2005.

REINSURANCE

In insurance, the insured transfers his risk to the insurer. This primary insurer transfers a part or all of the risks he has insured to another insurer to reduce his own liability (the risk that he has assumed). This is known as reinsurance. Reinsurance is primarily an insurance of risks assumed by the primary insurer known as the ceding company. This risk is shifted to another insurer known as the reinsurer. The ceding company may shift part or all of the insurance originally written to the reinsurer. The amount of the insurance retained by the ceding company for its own account is called the retention. Retention is the amount of risk that an insurer is prepared to take on his own account. The amount of the insurance ceded to the reinsurer is known as the cession. The proportion of risk to be retained by the ceding company depends on

factors such as company's assets and investment income, portfolio of the risks premium levels, inflation, and reinsurance market conditions.

Reinsurance operates on the same principle as direct insurance, i.e., to spread sharing of risks as widely as possible. The insurers seek protection of their own risk by reinsuring with reliable reinsurers. Reinsurance evolved as a natural corollary to insurance. Reinsurance is used for several reasons:

- To increase the company's underwriting capacity which, in turn, would help to render improved service to the reinsured and expand the market.
- To spread the risks with as many insurers as possible.
- To obtain valuable advice and assistance with respect to pricing, underwriting practices, retention, and policy coverage.
- To stabilise profits by leveling out peak risks/losses.
- To provide protection against catastrophic losses arising due to natural disasters, individual explosions, airline disasters and so on.
- To retire from the business or class of business or territory.

The reinsurance business assumes greater importance in the event of war and natural calamities when the smaller insurance firms find themselves unable to take on the full risk due to their lower capital base.

Types of Reinsurance

There are two-types of reinsurance: (i) Facultative and (ii) Treaty.

Facultative reinsurance is a reinsurance in which the reinsurer can accept or reject any risk presented by the ceding company (insurance company seeking reinsurance). This means that it is not mandatory for the reinsurer to accept the cover and he will accept it after naming his price terms and conditions. The reinsurer has the freedom to reject sub-standard risks if it so desires. The reinsurer retains the flexibility to accept or reject each application for reinsurance. The ceding company also gets freedom in respect of the portions of the risk to be reinsured and the choice of the reinsurer. Before underwriting any insurance, the ceding company determines whether reinsurance can be obtained. It contacts several reinsurers and if a willing reinsurer is found, both (ceding company and reinsurer) enter into a valid contract. The ceding company must disclose full information relating to the risk concerned to ensure validity of the contract. Facultative insurance offers several advantages such as increasing flexibility and the underwriting capacity of the ceding company. It is frequently used when a large amount of insurance is to be written. It stabilises the insurer's profits by shifting large losses to the reinsurer. However, it creates a sense of insecurity, as the ceding company may not always be successful in insuring its business. This uncertainty leads to delay in the issue of policy.

Treaty reinsurance means the ceding company is obliged to cede and the reinsurer is obliged to accept an agreed share of all reinsurance of the type defined in the contract. Treaty insurance is automatic and certain as business that falls within the scope of the agreement is automatically reinsured, according to the terms of the treaty. The ceding company has not to shop around for reinsurance before the policy is written. This system is beneficial also to reinsurers as they are assured of a regular flow of business. However, reinsurers could incur losses if the ceding company writes bad business or charges inadequate rates.

Reinsurance Treaties Reinsurance treaties can be of different types such as quota-share treaty, surplus share treaty, excess of loss treaty, and reinsurance pool. Under a quota-share treaty, the ceding company and the reinsurer agree to share a fixed proportion of premium and losses. The ceding company retains for its own account a certain percentage of such risk. In other words, the ceding company's retention limit is stated as a fixed percentage. This treaty is popular among new and unknown insurers.

Under a surplus-share treaty, the reinsurer agrees to accept insurance in excess of the retention with the ceding company up to some maximum amount. The ceding company has complete discretion in respect. Eve retention. The ceding companies which are financially sound can afford to have substantial retentions. The premiums and losses are shared based on the fraction of total insurance retained by the ceding company and the reinsurer.

Under an excess-of-loss treaty, losses in excess of the retention limit are covered by the reinsurer up to some maximum limit. It is a blanket agreement where all the claims made on local companies, above a certain the limit, are reimbursed by the reinsurers. This treaty is useful for protection against catastrophic losses. At the beginning of every financial year, non-life insurance companies have to renew their excess of loss reinsurance in the international market.

A reinsurance pool is a pool of reinsurers who jointly underwrite insurance as it may not be possible for the single insurer alone to write large amounts of insurance.

The pricing and terms and conditions of reinsurance contract are based largely on the underwriting capacity as in the international market.

The two largest reinsurance companies Munich Re and Swiss Re, have combined stock market value ofi tnVi $50 bn (£33 bn) and are seen as bell-wethers for the reinsurance industry. Munich Re has its presence in India through two ventures with Paramount Healthcare who are in the business of third party administration and healthcare management.

Reinsurance Business in Life and General Insurance

Reinsurance of life insurance business is less complex as compared to general insurance business. The Life Insurance Corporation of India (LIC) has the financial strength and capacity to absorb risks fully. The number of life policies reinsured as well as the total sum of risk reinsured is quite insignificant.

The need for reinsurance is higher in case of general insurance as it involves complex risks. In the post independence period, the Indian general insurers obtained the reinsurance cover from foreign reinsurance companies. This led to a drawing of foreign exchange. Hence, to maximise retention and to minimise the drain of foreign exchange, the general insurance business was nationalised.

In 2000, the outgo of premium money by way of reinsurance was around Rs 10 billion. In order to increase the retention of premia in India, the role of General Insurance Corporation of India (GIC) was reinforced as the official reinsurer by making an obligatory cession of 20 per cent of insurance business by the private insurance companies, written in India, to GIC.

IRDA has also issued regulations relating to both life and non-life reinsurance in 2000. To develop domestic reinsurance market capacity, IRDA stipulated that insurers should offer an opportunity to other Indian insurers to participate in facultative and treaty surpluses before placement of such cessions outside India.
Life Insurance-Reinsurance Regulations, 2000.

- Every life insurer shall draw up a program of reinsurance in respect of lives covered by him.
- The profile of such a program, which shall include the name(s) of the reinsurers with whom the reinsurer proposes to place business shall be filed with the Authority (IRDA) at least forty-five days before the commencement of each financial year, by the insurer. Provided that the Authority may, if it considers necessary, elicit from the insurer any additional information, from time to time, and the insurer shall furnish the same to the Authority forthwith.
- The Authority shall scrutinise such a programme of reinsurance as referred to in sub-regulation (2) and may suggest changes, if it considers necessary, and the insurer shall incorporate such changes forthwith in his programme.
- Every insurer shall retain the maximum premium earned in India commensurate with this financial strength and volume of business.
- The reinsurer chosen by the insurer shall enjoy a credit rating of a minimum of BBB of Standard and Poor or equivalent rating of any international rating agency.

Provided that placement of business by the insurer with any other reinsurer shall be with the prior approval of the Authority, provided further that no program of reinsurance shall be on original premium basis unless the Authority approves such program. Provided further that no life insurer shall have reinsurance treaty arrangement with its promoter company or its associate/group company, except on terms which are commercially competitive in the market and with the prior approval of the Authority, which shall be final and binding.

Every insurer shall submit to the Authority statistics relating to its reinsurance transactions in such forms as it may specify, together with its annual accounts.
Inward Reinsurance Business

1. Every insurer who wants to write inward reinsurance business shall adopt a well-defined policy for underwriting inward reinsurance business.
2. An insurer shall ensure that decisions on acceptance of reinsurance business are made by persons with adequate knowledge and experience, preferably in consultation with the insurer's appointed actuary.
3. An insurer shall file with the Authority, at least 45 days before the commencement of each financial year, a note on its underwriting policy indicating the clauses of business, geographical scope, underwriting limits, and profit objective.

IRDA has issued the necessary directions for the reinsurance programme of every insurer. They are:

1. The reinsurance programme of every general insurer, carrying on general insurance business, shall be guided by the following objectives, namely:
    - to maximise retention within the country.
    - to develop adequate capacity.

- to secure the best possible protection for the reinsurance costs incurred.
- to simplify the administration of business.

2. Every insurer shall offer an opportunity to other Indian insurers, including the Indian reinsurer to participate in its facultative and treaty surpluses before placement of such cessions outside India.
3. Insurers shall place their reinsurance business outside India with only those reinsurers who have over a period of the past five years enjoyed a rating of at least BBB (with Standard and Poor) or equivalent rating of any other international rating agency. Placements with other reinsurers shall require the approval of IRD A. Insurers may also place reinsurance with Lloyd's Syndicates after taking care to limit placements with individual syndicates commensurate with the capacity of the syndicate.
4. Surplus over and above the domestic reinsurance arrangements class-wise can be placed by the insurer independently subject to a limit of 10 per cent of total reinsurance premium ceded outside India being placed with anyone reinsurer. Where it is necessary to cede a share exceeding such limit to any particular reinsurer, the insurer may seek the specific approval of IRDA.

IRDA has constituted the Reinsurance Advisory Committee consisting of five persons having special knowledge and experience of business of reinsurance. The Reinsurance Advisory Committee has pegged the compulsory cession to the Indian reinsurer by the insurers carrying on general insurance business at 20 per cent subject to limits in fire, engineering, and energy business. Cessions in respect of public and product liability business have also been pegged at 20 per cent on quota share basis without any limits. The Committee has also specified commissions and profit commissions for each class of business besides outlining the procedures for maintenance and settlement of accounts. Profit commissions shall be applicable on the aggregate results of statutory cessions portfolio at the rate of 20 per cent.

The reinsurance market in India is estimated at Rs 1500-1800 crore, with mc having a 40 per cent share. The domestic insurance companies reinsure the remaining 60 per cent in the global market through a reinsurance broker. The largest domestic reinsurance clients include ONGC, IOC, Indian Airlines and Air India.

LESSON 22
INSURANCE SERVICES: REGULATORY FRAMEWORK - II

Lesson Objectives: To understand the regulatory requirements of the insurance sector and role of IRDA in it.

Dear students, we continue our discussion from last session, on regulatory framework of insurance services in India.

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REGULATORY FRAMEWORK IN RESPECT OF INSURANCE

Contract of insurance may be looked upon as a special type of contract between two parties called 'the insurer' and 'the insured'. In this contract 'the insurer', for a premium, undertakes to pay to the 'insured' a fixed amount of money on the happening of certain event. Since it is a contract, it has to satisfy or meet all the requirements of a valid contract laid down in section 10 of the Indian Contract Act 1872, which states that, "all agreements are contracts, if they are made by free consent of the parties, competent to contract, for a lawful consideration and with a lawful object and which are not expressly declared to be void." Therefore, like all other contracts a contract of insurance shall also meet the following requirements:

(a) agreement (offer & acceptance)
(b) free consent of the parties
(c) parties must be competent to contract
(d) there must be lawful consideration
(e) the object must be lawful
(f) it should not be expressly declared to be void

Further, contract of insurance should be based on the principles of insurance, specifically speaking the legal principles of insurance discussed earlier. In India, the contract of insurance should further comply with provisions of the Insurance Act 1938, regulatory provisions of Insurance Regulatory & Development Authority Act, 1999 and the Indian Stamps Act 1899.

INSURANCE ACT, 1938

The Insurance Act, 1938 contains important provisions relating to insurance sector/ service in the country. Important provisions are discussed briefly in the following pages.

Eligibility. Any class of insurers can carryon insurance business in India unless he is

(i) a public company
(ii) a society registered under the Co-operative Societies Act. 1912
(iii) a body corporate incorporated outside India other than a private company.

Registration. (i) Every person who is desirous of doing particular class of insurance business shall obtain a certificate of registration from the Authority.

(ii) A person who is carrying on any class of insurance business in India, on or before the commencement of the IRDA Act. 1999 shall make an application for such resgistration within 3 months from the date of commencement of such Act.

Documents to be filed. Every application for registration shall be accompanied by the following documents.

(i) A certified copy of the memorandum and articles of association.

(ii) Name and address of the directors and their occupation.

(iii) A statement of the class or classes of insurance business done or to be done. A certificate from RBI showing that the requisite amount required to be deposited u/s 7 has been deposited.
   (a) In case of life insurance business a sum equal to I % of his total gross premium written in India not exceeding 10 crores.
   (b) In case of general insurance business a sum equal to 3 % of his total gross premium written in India not exceeding Rs. 10 crores.
   (c) In case of re-insurance business a sum of Rs. 20 crores.
   (d) In case of marine insurance Rs. 100,000 only.

(iv) A declaration verified by on affidavit made by the principal officer of insurer authorised in that behalf that the requirement as to paid up equity capital or working capital have been complied with.
   (a) In case of life insurance or general insurance paid up capital required is Rs. 100 crore.
   (b) In case reinsurance business. Rs. 200 crore.

(v) A certified copy of published prospectus and standard policy forms of the insurer, terms and conditions offered in connection with insurance policies, statements of the assured rates along with a certificate from the actuary certifying that such rates, terms and conditions are workable and sound. But in case of general insurance business other than motor car insurance and workman compensation, the above requirement should be complied with only if they are available.

(vi) The receipt showing payment of fee of Rs. 50,000 for each class of business.

Grant of Certificate. After satisfying itself as to the soundness of the management of the applicant, volume of its business, adequacy of the earning prospects and that the interest of the public would be served and all other requirements of registration are complied with the Authority may register the applicant and grant a certificate of registration.

Cancellation of Registration. The Authority may cancel the registration of an insurer if he fails to comply with requirements of deposits with RBI, transfer his business, contravenes any requirement of the Insurance Act, do not pay any claim within 3 months of final court judgment or defaults in complying any of the provisions of UC Act/GIC Act/ Companies Act/FEMA.

Renewal of Registration. The insurer has to file an application for renewal before 31st December of preceding year along with evidence of payment of requisite fee.

Fee. Fees may vary according to total gross premium written direct in India during the proceeding year of application subject to 1/4th percent of such premium income or

Rs. 5 crore' whichever is less, and a minimum of Rs. 50,000 for each class of business. In case of reinsurance business, the total premium in respect of reinsurance accepted by him in India would be taken into account instead of total gross premium written direct in India. The authority may impose penalty in case application is not filed within the specified date.

Capital Requirement. The capital of life insurance companies should consist of only ordinary shares each of which has a single face value. The paid-up amount should be same for all shares whether existing or new. The company should maintain a register of shareholders containing their names, addresses. IRDA's approval is required if the holding of transferee company is likely to exceed 2.5% or 5% of paid up capital or where nominal value of shares exceeds 1% of the paid up capital of the insurance company.

Financial Statements. Every insurer is required to prepare a balance sheet, a profit and loss account, a receipts and payments account, a revenue account at the end of each financial year in accordance with regulations of IRDA Act in respect of financial statements. Separate funds accounts of shareholders and policy-holders should be maintained.

Investigation by Actuary. Every insurer who is carrying on life insurance business should get the investigation, done by an actuary, into financial conditions including a valuation of liabilities. An actuary should submit his report in the form of an extract made in accordance with the manner specified by the IRDA. A statement in prescribed form and manner should be appended to every such abstract at least once every three years.

Insurance Business in Rural/Social Sector. The Insurance Act, 1938 requires all insurers to undertake such % age of their insurance business including insurance for crops, in the rural social sector as specified by the IRDA. Also they should provide life/general insurance services in the form of policies to

1. the persons residing in the rural sector;
2. working in the unorganised sector;
3. economically weaker/backward classes of society;
4. to other categories as specified by the IRDA.

Registration of Principal/Chief/Special Agent(s). For an insurer to be a principal agent, chief agent or special agent it is necessary to get himself registered with IRDA. Principal agent is not an employee of the insurer. He performs administrative and organising functions for a commission, secures general insurance business, wholly or in part, through insurance agents on behalf of the insurer. The chief agent performs the same functions as are performed by principal agent. Special agent is a person who does not perform any administrative function but who procures insurance business for a commission.

Application has to be filed, in the prescribed form along with requisite fee of Rs. 25 for principal/chief agent and Rs. 10 for a special agent, to the IRDA. The certificate will be granted provided he fulfils the eligibility criteria. The certificate remains valid

for 1 year after which it has to be renewed against the payment of a fee. The certificate may be cancelled if the principal agent/chief special agent fails to comply with or contravenes any of the eligibility criteria.

Regulation of Employment of Principal/Chief/Special Agents. Terms and conditions relating to the employment of principal agent as agreed between the insurer and the agent should be written down in writing. A copy of the contract, duly certified should be furnished by the insurer, to the IRDA within 30 days of entering into such contracts. The insurer must maintain a register containing the names, addresses, date of appointment in respect of principal agents and chief/special agents.
Similarly the contact between (i) a life insurer and a chief agent (ii) life insurer and special agent (iii) a chief agent and special agent should be in writing. A copy of the contract to be submitted within 30 days to IRDA. The contract remains valid for 10 years. The chief agent should maintain a register containing the particulars of special agents appointed by him.

Licensing of Surveyors and Loss Assessors. Any person who is desirous of acting as a surveyor/loss assessor in respect of general insurance business can apply to IRDA by making payment. The licence is valid for 5 years and has to be renewed again for 5 years against a payment as specified by IRDA not exceeding Rs. 200. The applicant should fulfill any of the following criteria in order to be eligible:

(i) has practised as a surveyor/loss assessor;
(ii) holds a degree in any branch of engineering of a recognized university;
(iii) be a fellow/associate member of ICW A/ICAI ;
(iv) possess actuarial qualifications/hold a degree or diploma of any recognised university/institute in relation to insurance;
(v) hold a diploma in insurance granted/recognised by the government;
(vi) possess such other technical qualifications as may be specified by the IRDA.

If the holder of licence makes any false statement with regard to the eligibility or suffer from any of the disqualifications mentioned above, then his licence may be cancelled by authority. IRDA has laid down code of conduct to be followed by the surveyors/loss assessors.

The IRDA, ACT

The Insurance Act, 1938 provided comprehensive regulation of the insurance business in India. It created a powerful supervisory authority in the Controller of Insurance. The Controller of Insurance had the powers to direct, advice, caution, investigate, inspect, search, seize, amalgamate, authorise, register and liquidate insurance companies. However after the nationalisation of life insurance, in 1956 and General Insurance in 1972, the applicability of these provisions was extremely diluted. Due to nationalisation, most of the powers of the Controller of Insurance got vested in the LIC and GIC.

In 1993, Govt. of India, with a view to examine the structure of the Insurance industry and to recommend changes to make it more competitive and efficient, in the light of structural changes in the other segments of the financial system, appointed a committee under the chairmanship of former Governor of Reserve Bank of India, Sh. R.N. Malhotra. The committee submitted its report, in January 1994. It recommended

setting up of an independent Insurance Regulatory Authority on the lines of Securities and Exchange Board of India. The Govt. accepted the recommendation and in January 1996 established an interim Insurance Regulatory Authority. In 1999 the bill titled as Insurance Regulatory and Development Authority Bill 1999 was introduced in the parliament along with three schedules containing the amendments to the Insurance Act, 1938, Life Insurance Corporation Act, 1956, and General Insurance Business, (Nationalisation Act, 1972). After discussion and debate the Bill became an Act known as Insurance Regulatory and Development Authority (IRDA) Act, 1999.

THE SALIENT FEATURES OF IRDA, ACT

Following are the salient features of the Act:

1. Act to Establish the Regulatory Authority

The preamble of the Act states that it is, "An Act, to provide for the establishment of an authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the Insurance Industry and for matters connected there with or incidental thereto." It is clear from the preamble that the Act is to establish authority which will:

a) Protect the interests of holders of insurance policies;

b) Regulate, promote and ensure orderly growth of Insurance Industry;

c) and other matters which may be connected with or incidental to the above mentioned purposes.

Section 3 of the Act, ,provides that the authorities shall be a Body Corporate with the name "The Insurance Regulatory Authority". It also provides that it , shall have the perpetual' succession and a common seal. Subject to the Act, it shall have the power to acquire, hold and dispose of the property both movable and immovable. It shall have contractual authority as well as power to sue and be sued.

2. Composition of Authority

Section 4 of the Act, lays down the Composition of the Authority to be as follows:

The Authority shall consist of the following members, namely:

(a) a Chairperson; ,

(b) not more than five whole-time members;

(c) not more than four part-time members;

to be appointed by the Central Government from amongst persons of ability, integrity and standing who have knowledge or experience in life insurance, general insurance, actuarial science, finance, economics, law, accountancy, administration or any other discipline which would, in the opinion of the (Zentral Government, be useful to the Authority.

Provided that the Central Government shall, while appointing the Chairperson and the whole-time members, ensure that at least one person each is a person having knowledge or experince in life insurance, general insurance or actuarial science, respectively.

The Chairman and every other whole time member shall hold an office for a term of five years from the date of his joining and shall be eligible for reappointment. The age of retirement for whole time members is sixty two years and for the Chairperson sixty five years. Similarly, there can be part time members.

The Chairman and the whole time members are barred from taking up an employment within two years from leaving the office under Central Govt., State Govt. or an insurance company except with the approval of the Central Govt.

3. Insurance Advisory Committee

Section 25 of the Act provides that an Insurance Advisory Committee consisting of not more than twenty five members (including ex-officio) wilt be constituted. The members will represent the interest of commerce, industry, transport, agriculture, consumer forum, surveyers, agents, inter-mediaries, organisations engaged in safety and loss prevention, research bodies and employees' association of the Insurance sector. The Chairperson and the members of the Authority shall be ex officio members of the committee.

The Authority in consultation with the committee can make regulations to achieve its objectives. In exercise of this authority IRDA has framed a number of regulations. The salient features emerging out of these regulations are discussed in - subsequent parts.

4. Ending the Monopoly of LIC and GIC

Section 30, 31, & 32 of the IRDA Act have amended certain provisions of the Insurance Act, 1938, LIC Act of 1956 and the General Insurance Business (Nationalisation) Act, 1972 in line with First, Second and third schedule of the Act. These amendments have ended the exclusive privilege of LIC, GIC and its subsidiaries to carry on life and general insurance business respectively. Thus, it has allowed the entry of private sector into life and non-life insurance.

5. The Insurance Business opened to Indian Companies Only

The business has been opened to Indian Companies only. The Indian Company for the purpose has been defined by Section 2 of the Insurance Act, 1938, as follows.

An Indian insurance company has been defined in Section 2 as an insurer being a company:

(a) formed and registered under the Companies Act, 1956;
(b) in which the aggregate holdings of equity shares by foreign company either by itself or through its subsidiary companies or nominees do not exceed 26 % of paid up equity share capital of such Indian Insurance Company;
(c) The sole purpose is to carry on life insurance or general insurance or re-insurance business. .

As per Clause 11 of the IRDA (Registration of Indian Insurance Companies) Regulations 2000, the quantum of paid up equity capital held by the foreign company either by itself or through its subsidiary company or its nominees, foreign investors, non- resident Indians, overseas corporate bodies and multinational agencies will be considered for determining 26 % of the paid up equity capital held by the foreign company.

6. Registration

Section 3 of the Insurance Act, 1938 read with IRDA (Registration of Indian Insurance Companies) Regulations, 2000 provide that any applicant desirous of carrying on Insurance business in India shall make a requisition for registration

application in Form IRDA/RI. The applicant shall make a separate requisition for registration application for each class of business of insurance i. e. life insurance business consisting of linked business, non-linked business or both, or general insurance business including health insurance business.

The applicant shall be an Indian insurance company who shall submit along with the application:

(i) certified copy of the memorandum and articles of association;
(ii) names, addresses and occupations of the directors and principal officer;
(iii) a statement of class(es) of insurance business proposed to be carried on;
(iv) a statement indicating the sources that will contribute the share capital.

The authority on being satisfied may accept the application. In case if it rejects, the applicant may be given reasonable opportunity to represent his case. Alternatively, he may approach the authority with fresh request for registration after a period of two years from the data of rejection with a new set of promoters.

An applicant whose requisition for registration application has been accepted by the Authority shall make an application in Form IRDA/R2 for grant of certificate of registration. The application shall be accompanied by:

(a) documentary proof evidencing the making of deposit under Section 7 of Act;
(b) evidence of having paid up equity capital of Rs. 100 crores or more in case of life insurance or general insurance business;
(c) evidence of having paid up equity capital of Rs. 200 crores or more in case of reinsurance business;
(d) an affidavit by the principal officer and the promoters of the applicant certifying that the requirements of paid up share capital and deposits referred in Section 6 and 7 have been satisfied. Principal Officer means any person connected with the management of the applicant or any person upon whom the Authority has served notice of its intention of treating him as the principal officer thereof;
(e) a statement indicating the distinctive numbers issued to each promoter and shareholder in respect of share .capital of the applicant;
(f) an affidavit by the Principal Officer and the promoters of the applicant certifying that paid up equity capital of the foreign company does not exceed 26 %.
(g) a certified copy of the published prospectus, if any;
(h) a certified copy of the standard forms of the insurer and statement of assured rates, advantages, terms and conditions to be offered in connection with the insurance policies together with a certificate by an actuary in case of life insurance business that such rates, advantages, terms and conditions are workable and sound;
(i) a certified copy of the memorandum of understanding entered into between the Indian promoters and the foreign promoters;
(j) original receipt showing payment of fee of Rs. 50,000/- for each class of business. This fee shall be remitted by a bank draft issued by any scheduled bank in favor of the Insurance Regulatory and Development Authority payable at New Delhi;

(k) a certificate from a practicing Chartered Accountant or practicing Company Secretary certifying that all requirements relating to registration fees, share capital, deposits and other requirements of the Act have been complied with.

The Authority shall consider the following matters before grant of a certificate to the applicant:

(i) record of the performance of each of the promoters in the fields of business/profession they are engaged in;
(ii) record of performance of the directors and persons in management of the promoters;
(iii) capital structure.
(iv) nature of insurance products;
(v) extent of obligations to provide life insurance or general insurance policies to persons residing in rural sector, workers in unorganized sector, informal sector or economically vulnerable or backward classes of the society;
(vi) organisation structure;
(vii) the planned infrastructure including branches in rural areas to effectively carry out insurance business;
(viii) the level of actuarial and other professional expertise with the management.

The Authority will grant a certificate of registration in IRDA/R3 and shall give preference to those applicants who propose to carry business of providing health cover to the individuals. An existing Insurance Company i.e. Life Insurance Corporation of India, General Insurance Corporation of India, its four subsidiaries will also require registration under the Act. It shall make an application within three months of the commencement of IRDA Act, 1999.

7. Renewal of Registration

An insurer who has been granted a certificate shall make application in Form IRDA/R5 for renewal of certificate before the 31st of December each year and such application shall be accompanied by evidence of payment of fee which shall be higher of the following:

(a) Rs. 50,000/- for each class of Insurance business and
(b) One fourth of one percent of total gross premium written direct by an insurer in India during the financial year proceeding the year in which the application for renewal is required to be made or Rs. 5 crore whichever is less (in case of general or life insurance business).

8. Capital Adequacy Requirement

Any Insurance company carrying the business of life insurance, general insurance or re-insurance shall not be registered unless it has paid up equity capital of Rs. 100 crores in case of a person carrying life insurance or general insurance business and a paid up equity capital of Rs. 200 crores in case of a Company carrying business exclusively as reinsurer.

In terms of section 6AA of the Insurance Act, 1938, a promoter shall not at any time hold more than 26% of the paid up equity capital in an Indian insurance company. In case where it holds more than 26%, it shall divest in a phased manner the share capital in excess of 26 % after the period of ten years from the date of commencement of business.

9. Deposits

Section 7 of the Act provides that an insurance company shall in respect of the insurance business carried by it in India deposits and keep deposited with the Reserve Bank of India either cash or approved securities.

(a) In the case of life insurance business, a sum equivalent to one percent of his total gross premium written in India in any financial year and not exceeding Rupees ten crores.
(b) In the case of general insurance business, a sum equivalent to three percent of his total gross premium written in India in any financial year not exceeding Rs. ten crores.
(c) In case of re-insurance business, a sum of Rupees twenty crores.

If at any time, any part of the deposit is used in discharge of any liability of the insurer, the insurer shall deposit such additional sum in cash or approved securities estimated at the market value of the securities on the day of deposit or partly in cash and partly in such securities to make good the amount so used. This deposit shall be deemed to be a part of the assets of the insurer and shall not be susceptible to any assignment or charge nor shall it be available for discharge of any liability of the insurer other than liabilities arising out of policies of insurance. It shall also not be liable to attachment in execution of any decree except a decree obtained by a policy- holder.

10. Accounts and Balance Sheet

Section 11 of the Insurance Act, 1938 provides that an insurance company shall at the -expiry of each financial year, prepare:

a. Balance sheet in accordance with the regulations and form set in Part I and Part II of the first schedule.
b. Profit and Loss Account in the regulations and form set forth in second schedule.
c. A Revenue Account in respect of each class of Insurance business in accordance with the regulations and form set forth in third Schedule.
d. Receipt and payments Account.

A Life Insurance Company carrying insurance business shall in each year cause an investigation to be made by an actuary into the financial condition of the life insurance business carried by the Company including valuation of its liabilities and shall cause an abstract of the report of such actuary to be made. Actuarial Report and abstract shall be made in accordance with the regulations and requirements in conformity with fourth schedule. The abstract of the report shall be made in the manner specified by the IRDA (Actuarial Report) Regulations, 2000.

Besides this, an Insurer carrying life insurance or general insurance business shall comply with the requirements of schedule A or schedule B of the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. The accounts and statements will be signed by the chairman, if any and two directors and the principal officer of the company and will be accompanied by a statement containing the names, description and occupations of and the directorships held by persons in charge of the management. The audited accounts, statements and

the abstracts shall be printed and four copies shall be filed with the Authority within six months.

11. Investment of Assets.

Section 27 provides that the Authority shall in the interest of policy holders, by means of regulations, specify the time, manner and conditions of investments of assets in the infrastructure and social sector. Under the new norms at least 50% of the funds will be parked in the government securities and insurers can invest up to 20 % of their funds in corporate debts in addition to 15 % in market investment. Infrastructure has been included in the social sector, where companies have to mandatorily invest at least 15% of their funds.

Infrastructure facility means:

(i) road, highway, bridge, airport, port, railways, road transport systems, water supply project, irrigation project, industrial, parks, water treatment systems, .sanitation and sewage. systems;
(ii) generation or distribution or transmission. of power;
(iii) telecommunication;
(iv) housing project;
(v) any other public facility of a similar nature.

An insurer shall not directly or indirectly invest outside India, the funds of the policy holders.

12. Insurance Business in Rural or Social Sector

In terms of Section 32B and Section 32C, every insurance company shall discharge the obligations to provide life insurance or general insurance policies to the persons residing in the rural sectors, workers in the unorganized or informal sector or for economically vulnerable or backward classes of society and other categories of persons as may. be specified by regulations made by the authority and such insurance policies shall include insurance for crops. The Regulatory Authority has issued the IRDA (Obligations of Insurer to Rural or Social Sector) Regulations, 2000. Rural sector has been defined as any place which as per the latest census has a:

(i) a population of not more than five thousand;
(ii) a density of population is not more than 400 persons per sq. km.;
(iii) at least seventy-five percent of the male working population is engaged in agriculture.

"Social sector" includes unorganized sector, informal sector. economically vulnerable or backward classes and other categories, both in rural and urban areas.

"Unorganized sector" includes self-employed workers such as agricultural labourers, bidi workers, carpenters, construction workers, fishermen, handicraft artisans, khadi workers, lady tailors etc.

"Economically vulnerable or backward classes" means persons living below the poverty line.

Every insurer carrying on insurance business shall undertake to perform:

(a) the following obligations in the rural sector
    (i) In case of life insurer
    * 5 % in the first financial year
    * 7 % in the second financial year
    * 10% in the third financial year

* 12 % in the fourth financial year
* 15% in the fifth financial year of total policies written direct in that year.

(ii) In respect of a general insurer
* two per cent in the first financial year
* three per cent in the second financial year
* five per cent thereafter, of total gross premium income written direct in that year.

(b) Social sector, in respect of all insurers:
* 5000 lives in the first financial year
* 7500 lives in the second financial year
* 10,000 lives in the third financial year
* 15,000 lives in the fourth financial year
* 20,000 lives in the fifth financial year

13. Power of investigation and Inspection

The Authority may by. an order direct any person to investigate the affairs of the insurer and to report to it. It may take the services of auditor or-actuary for the purpose of assisting him in any investigation. The authority on receipt of the report may require the insurer to take such action in respect of any matter arising out of the report or cancel the registration of the insurer or direct any person to apply to the court for the winding of the insurer.

14. Limitation of Expenditure on Commission

The insurer shall not pay to an insurance agent by way of remuneration or commission in respect of any policy of life insurance, an amount exceeding:

(a) where the policy grants an immediate annuity or a deferred annuity in consideration of a single premium, 2% of that premium;

(b) where the policy grants a deferred annuity in consideration of more than one premium, 72 per cent of first year's premium and 2% of each renewal premium payable on the policy;

(c) In any other case, 35 % of the first year's premium, 72 per cent of the second and third year's renewal premium and thereafter five per cent of each renewal premium payable on the policy;

(d) where the policy relates to fire, marine or misc. insurance, total commission paid shall not exceed 15% of the premium payable on the policy.

15. Licensing of Insurance Agents

Section 42 of the Insurance Act, 1938 read with the IRDA (Licensing of Insurance Agents) Regulations, 2000 provides that any person desiring to obtain a licence to act as an insurance agent or as a composite insurance agent shall make an application to the designated person in form IRDA-Agents-V A, if the applicant is an individual and in Form IRDA-Agents~ VC, if the applicant is a firm or company. The regulations have defined the term 'person' as

(i) an individual
(ii) a firm

(iii) a Company, formed under the Companies Act 1956 and includes a banking company.

A designated person is an officer-in-charge of marketing operations as specified by the insurer and authorized by the Authority to issue or renew licences under these regulations. Insurance agent is a person who receives payments by way of commission or any other remuneration in consideration of his soliciting or procuring insurance business including business relating to the continuance, renewal or revival of the policies of insurance.

An applicant desirous to be composite insurance agent will have to submit two separate applications. Composite Insurance Agent is a person who holds a licence to act as an insurance agent for a life insurer and general insurer. The designated person may on receipt of application along with a fee of Rs. 250/satisfy himself that the applicant possesses:

(a) Requisite qualification. He should have a minimum qualification of 12th standard pass or equivalent examination where the applicant resides at a place with a population of five thousand or more as per the last census. In cases where the applicant resides in any other place, the qualification shall be 10th standard or an equivalent examination.

(b) Practical training. Practical training includes orientation particularly in the area of insurance sales, service and marketing through training manuals as approved by the Authority. The applicant should have completed from an approved institution at least 100 hours practical training in life or general insurance business. It may be spread over three to four weeks. In case of composite insurance business, the applicant shall have completed from an approved Institution, at least 150 hours practical training which may be spread over six to eight weeks. Approved Institution is an institution engaged in education and/or training particularly in the area of insurance sales, service and marketing approved and notified by the Authority.

Where the applicant happens to be an Associate/fellow member of the Insurance Institute/C.A. Institute/C.S. Institute/ICW A Institute or MBA or any other qualification recognized by the Central Government or State Government, the applicant should have completed at least 50 hours of practical training from an approved institute and in case of composite insurance agent he shall have completed at least 70 hours of practical training in cases.

(d) *Examination.* The applicant has passed the pre- recruitment examination in life or general insurance business conducted by the Insurance Institute of India, Mumbai or any other examination body. Examination Body means an institute which conducts pre-recruitment test for insurance agent and which is duly recognized by the Authority.

(e)

1. has furnished the application completed in all respects.
2. has the requisite knowledge to solicit and procure insurance business and
3. is capable of providing necessary services to the policyholder

In case of corporate agents, all directors of the company or in a finn, all its partners must possess the requisite qualifications, practical training and should have passed examination. Licence issued shall remain in force for a period of three years and may be renewed for a further period of three years at anyone time.

The functions of an insurance agent shall include

- identify himself and the insurance company of which he is an agent, disclose his licence to the prospect. Prospect means a potential purchaser of an insurance product,
- disseminate information in respect of insurance products offered for sale,
- disclose the scales of commission in respect of the insurance product to the prospect,
- indicate the premium to be charged by the insurer. Premium is the price for the risk undertaken by the insurers,
- explain to the prospect the nature of information required in the proposal form by the insurer,
- bring to the notice of insurer any adverse habits or income inconsistency of the prospect through a report called insurance agent confidential report,
- inform promptly the prospect about the acceptance or rejection of the proposal by the insurer,
- to render necessary assistance to the policyholders or claimants in complying with the requirements for settlement of claims. .

The provisions relating to qualifications, practical training and examination shall not apply to existing agents. Notes to Form V A provide that an insurance agent shall work exclusively for one insurance company i.e. for one life insurer. one general insurer or both. However, the application form of a corporate insurance agent does not specify any such limitation. Section 42 of the Insurance Act, 1938 prescribes certain *disqualifications* for an insurance agent:

(a) the person is minor;
(b) the person is of unsound mind;
(c) guilty of misappropriation;
(d) he does not possess prescribed qualifications and practical training;
(e) has not passed examination as specified by the Authority;
(f) violation of code of conduct.

Every insurance company employing insurance agents shall maintain a register disclosing the name and address of every agent appointed by him, the date of appointment, date of cessation of appointment.

16. Issue of Licence to Insurance Intermediary

Section 42D of the Act provides that the Authority shall have the power to issue licence to other intermediaries in the insurance segments and this licence will be valid for a period of three years. The Insurance Regulatory and Development Authority have framed draft broker regulations: Insurance brokers will be regulated in the following areas:

- registration,
- experience, training and qualification and othe;r restrictions on entry into the, profession,

- solvency requirements,
- professional indemnity or a minimum level of errors.
  There is also a central fund to protect clients against broker malpractice.

(a) Categories of Brokers. Clause 2(d) defines an Insurance broker as a person to whom licence has been granted by the authority to act as an insurance broker. The regulations have classified the insurance broker into four categories. Category lA shall be Direct General Insurance Broker engaged in insurance business but not reinsurance business. Category 1 B shall be a Direct Life Insurance Broker engaged in life insurance business but not in reinsurance business. Category II shall be a Reinsurance Broker while Category III shall be a Composite Broker whose functions will include Direct Insurance Broker and Reinsurance Broker. Category IV shall be an insurance consultant for risk management consultation.

(b) Functions of General and Life Insurance Broker.

- Obtaining detailed knowledge of the client's business and philosophy.
- Maintaining clear records of the client's business.
- Provision of providing technical advice to the client and advise on developments in insurance market and law.
- Maintaining a detailed knowledge of available markets.
- Selection and recommendation of an insurer or group of insurers.
- Negotiating with insurer on the client's behalf.
- Acting promptly on client's instructions and providing written acknowledgements and progress report.
- Collecting and remitting premiums and claims.
- Provide insurance consultancy services, risk management services.
- Assisting in the negotiation of claims.
- Maintaining precise records of past claims.

(c) Criteria for Grant of Licence. The Authority while examining the application for grant of licence shall, *inter alia*, consider the following:

(a) the infrastructure of the applicant include adequate office space, equipment and manpower to effectively discharge his activities.

(b) the applicant in his employment a minimum of two persons who have the experience to conduct the business of insurance broker;

(c) the applicant has minimum of two Directors possessing:

  (i) A minimum qualification of an Associate of the Insurance Institute of India or equivalent or any professional qualification from the institutions recognized by the Government in finance, law, engineering or business management.

  (ii) Practical training for specified period conducted by the National Insurance Academy, Pune.

(d) Capital adequacy requirement.

The draft regulations also specify capital adequacy requirement of the applicants seeking grant of licence.

Application for licence will be made in form B as mentioned in the draft regulations. The applicant shall on grant of licence be liable to pay fee to the Authority in

accordance with the Schedule II of these regulations. A licence granted to an insurance broker, in terms of these regulations shall remain valid for a period of three years from the date of issue thereof.

(d) Cancellation of Licence. A licence of an insurance agent may be cancelled if the insurance agent suffers from any disqualifications mentioned in section 42(4) of the Act. His licence and the identity card issued will be recovered from him by the designated person.

(e) Code of Conduct. Every insurance agent shall:

(a) identify himself and the insurance company of whom he is an insurance agent;
(b) disclose his licence to the prospect on demand;
(c) disseminate the requisite information in respect of insurance products offered for sale by his insurer and take into account the needs of the prospect while recommending a specific insurance plan;
(d) disclose the scales of commission in respect of the insurance product offered for sale, if asked by the prospect;
(e) indicate the premium to be charged by the insurer for the insurance product offered for sale;
(f) explain to the prospect the nature of information required in the proposal form by the insurer, and also the importance of disclosure of material information in the purchase of an insurance contract;
(g) bring to the notice of the insurer any adverse habits or income inconsistency of the prospect, in the form of a report (called "Insurance Agent's Confidential Report") along with every proposal submitted to the insurer, and any material fact that may adversely affect underwriting decision of the insurer as regards acceptance of the proposal, by making all reasonable enquiries about the prospect;
(h) inform promptly the prospect about the acceptance or rejection of the proposal by the insurer.
(i) obtain the requisite documents at the time of filling the proposal form with the insurer; and other documents subsequently asked for by the insurer for completion of the proposal;
(j) render necessary assistance to the policyholders or claimants or beneficiaries in complying with the requirements for settlement of claims by the insurer;
(k) advise every individual policyholder to effect nomination or assignment or change of address or exercise of options. as the case may be. and offer necessary assistance in this behalf, wherever necessary;

(ii) No insurance agent shall,

(a) solicit or procure insurance business without holding a valid licence;
(b) induce the prospect to omit any material information in the proposal form;
(c) induce the prospect to submit wrong information in the proposal for all or documents submitted to the insurer for acceptance of the proposal;
(d) behave in a discourteous manner with the prospect;
(e) interfere with any proposal introduced by any other insurance agent;
(f) offer different rates, advantages, terms and conditions other than those offered by his insurer;

(g) demand or receive a share of proceeds from the beneficiary under an insurance contract;
(h) force a policyholder to terminate the existing policy and to effect a new proposal from him within three years from the date of such termination;
(i) have, in case of a corporate agent, a portfolio of insurance business under which the premium is in excess of fifty per cent of total premium procured, in any year, from one person (who is not an individual) or one organisation or one group of organisations ;
(j) apply for fresh licence to act as an insurance agent, if his licence was earlier cancelled by the designated person, and a period of five years has not elapsed from the date of such cancellation;
(k) become or remain a director of any insurance company;

(iii) Every insurance agent shall with a view to conserve the insurance business already procured through him, make every attempt to ensure remittance of the premiums by the policyholders within the stipulated time, by giving notice to the policyholder orally and in writing.

(f) Remuneration of Brokers. Clause 15 provides for remuneration to be paid to brokers. According to it, the remuneration to brokers will be determined by market forces except in case of life and non life insurance who will be paid by way of brokerage an amount not exceeding 17.5 % of the premium payable on the policy. The brokerage levels prescribed may not, work in case of life' insurance brokers as here the policy continues for a certain number of years. The broker should be given brokerage as certain percentage of premium of first year and percentage on renewal premium also. The code of conduct as provided in the regulations provide that the broker must disclose all the fee or charges (not commission) which he proposes to charge from the client which will be in addition to the insurance premium. The broker shall advise the client in writing of the insurance premium, any fee or charges separately and the purpose related to services.

(g) Segregating Insurance Money. Clause 17 of the draft regulations provide that every insurance broker must treat all money received from or on behalf of insured as insurance money and that this shall be kept in a Insurance Bank Account with one or more approved scheduled banks. The broker shall ensure that all money received for or on behalf of insured is paid to the Insurance Bank Account and will remain there until it is passed on to the Insurance company. The insurance broker shall only remove from the insurance bank account, charges, fees to commission and interest received from any funds comprising the account. The regulations, however, are silent on the time frame within which the funds ought to be transferred from the Banker's Insurance Bank Account' to the Insurance Company.

(h) Solvency Requirement. The Insurance broker shall throughout the licence period maintain an excess of the value of assets over the amount of liabilities as solvency and shall vary according to the category of licence.

The insurance broker is required to furnish to the Authority the statement certified by the auditor that solvency requirement has been maintained.

(i) Professional Indemnity Insurance. Every Insurance broker shall take out and maintain a professional indemnity insurance cover throughout the validity of the

period of licence granted by the Authority. This cover must indemnify the insurance broker. For instance; the Composite Insurance Broker will have to take a cover equivalent to four times of brokerage and fees in a year subject to minimum limit of Rs. 6.00 crores. The brokers will be under obligation to maintain books of accounts, records, documents, i.e. book ledger, client ledger bank accounts, brokerage note etc. He shall prepare the balance sheet, profit and loss account, statement of fund flow which will be submitted to the Authority along with the auditor's report within 90 days of the close of the accounting year. The Insurance Broker shall furnish to the Authority un-audited financial results within 30 days of the close of the half year.

Besides this, the Authority has the right to inspect/suspend/cancel the licence, hold an enquiry before suspension, issue show-cause notices and orders levy penalties etc.

17. Tariff Advisory Committee

Section 64U provides that a Tariff Advisory Committee shall control and regulate the rates, advantages, terms and conditions that may be offered by that insurer in respect of general insurance business.

This Tariff Advisory Committee shall consist of members including chairman of the Authority, a senior officer of the office of the authority nominated to be as vice chairman of the committee and not more than 14 representatives of the insurance companies.

18. Licensing of Surveyors and Loss Assessors

Section MUM provides that a person shall not act as surveyors or loss assessors in respect of general insurance unless he holds a valid licence issued to him by the authority. Every person who attempts to act as a surveyor or loss assessor shall have to make an application to the authority and licence will be issued to him for a period of five years.

No claim in respect of a loss which has occurred in India which exceeds Rs. 20,000 in value or any policy of insurance shall be admitted in payments by 'the insurer, unless he obtains report on the loss from a person who holds the licence to act as a surveyor or loss assessor.

19. Sufficiency of Assets (Section 64 VA)

An insurer shall maintain, at all times an excess of assets over its liabilities of not less than the amount in case of an insurer carrying general insurance business, the solvency margin shall be the highest of the following:

(a) fifty crores Rupees (Rs. one hundred crores in case of reinsurer): or
(b) a sum equivalent to 20% of net premium income: or
(c) a sum equivalent to 30% of net incurred claims.

Net incurred claims means the average of net incurred claims during the specified period, not exceeding three proceeding financial years.

20. No Risk to Assume Unless Premium Received in Advance An insurance company shall not assume any risk in respect of any insurance business of which premium payable is received by him or is guaranteed to be paid by a person within such time or unless and until deposit of such amount is made in advance in the prescribed manner. Risk may be assumed not earlier than the date on which premium has been paid in

cash by the insurer. Where the premium is tendered .by means of postal money order or cheque sent by post, risk may be assumed on the date on which money order is booked or cheque is posted.

21. Reinsurance

If the insurers find that they have entered into a contract of insurance which is an expensive proposition for them or if they wish to minimize the, clearances of any possible loss, without at the same time, giving up the contract, resort is to have reinsurance. It is basically the practice of insuring again. The Company with which the public insurer is called a direct or ceding office and the Company accepting business from ceding office is called a reinsurer.

So, today we end our discussion here. You come prepared after studying the next chapter, which continues our discussion on regulatory framework of insurance services in India.

LESSON 23
INSURANCE SERVICES: REGULATORY FRAMEWORK - III

Lesson Objectives: To understand the regulatory requirements of the insurance sector and role of IRDA in it.

Dear students, we continue our discussion on regulatory framework in this session also.

IRDA (LIFE INSURANCE REINSURANCE) REGULATIONS, 2000

The Insurance Regulatory and Development Authority Act, 1999 in consultation with the Insurance Advisory Committee has made following regulations with regard to life insurance-reinsurance business.

A. Procedure to be followed for reinsurance arrangements draw programme.

(i) Every life insurer shall draw up a programme of reinsurance in respect of lives covered by him. The programme shall include the names of the programme shall be filed with the Authority, at least 45 days before the commencement of each financial year.

(ii) *Authority's powers*. (a) The authority may seek any additional information from the insurer, and the insurer shall furnish the same. (b) The Authority may suggest changes, if it considers necessary, and the insurer shall have to incorporate such changes in his programme.

(iii) *Credit rating*. The re-insurer shall have a credit rating of a minimum of BBB of Standard and Poor or equivalent rating of any international agency.

(iv) *Premium.* Every insurer shall retain the maximum premium earned in India commensurate with his financial strength and volume of business.

(v) *Filing of statistics.* Every insurer shall submit to the Authority statistics relating to its reinsurance transactions in such form as it may specify, together with its annual accounts.

B. Inward Reinsurance Business.

(i) Every insurer who wants to write inward reinsurance business shall adopt a well-defined underwriting policy for underwriting inward reinsurance business.

(ii) An insurer shall file with the Authority, at least 45 days before the commencement of each financial year, a note on its underwriting policy indicating the clauses of business, geographical scope, underwriting limits and profit objective.

(iii) An insurer shall also file any changes in the underwriting policy, if any.

IRDA (GENERAL INSURANCE REINSURANCE) REGULATIONS, 2000

Insurance Regulatory and Development Authority has, in consultation with the Insurance Advisory committee, framed following regulations with regard to general insurance-reinsurance business.

A. Procedure to be followed for reinsurance arrangements

(i) *Objectives of re-insurance*. The reinsurance program shall aim at achieving following objectives

- maximise retention within the country;'
- develop adequate capacity;
- secure the best possible protection for the reinsurance costs incurred;
- simplify the administration of business.
-

(ii) *Justify retention policy*. The authority may require an insurer to justify its retention policy and may make directions to ensure that Indian insurer is not merely fronting for a foreign insurer.

(iii) *Reinsurance as per Insurance Act*. Every insurer shall cede such percentage of the sum assured on each policy for different classes of insurance written in India to the Indian reinsurer as may be specified by the Authority in accordance with the provisions of Part IV A of the Insurance Act, 1938.

(iv) *Submission of reinsurance programme*. The reinsurance programme of every insurer shall commence from the beginning of every financial year and every insurer shall submit to the Authority, his reinsurance programmes for the forthcoming year, 45 days before the commencement of each financial year.

(v) *Filing of reinsurance treaty slip*. Within 30 days of the commencement of the financial year, every insurer shall file with the Authority a photocopy of every reinsurance treaty slip and excess of loss cover, cover note in respect of that year together with the list of reinsurers and their shares in the reinsurance arrangement;

(vi) *Business outside India*. Insurers shall place their reinsurance business outside India with only those reinsurers who have over a period of the past five years counting from the year preceding for which the business has to be placed, enjoyed a rating of at least BBB (with Standard and Poor) or equivalent rating of any other international rating agency" Placements with other reinsurers shall require the approval of the authority.

(vii) *Retention of business within India*. The Indian Reinsurer shall organise domestic pools for reinsurance surpluses in fire, marine hull and other classes in consultation with all insurers on basis, limits and terms which are fair to all insurers and assist in maintaining the retention of business within India as close to the level achieved for the year 1999-2000 as possible. The arrangements so made shall be submitted to the Authority within three months of these regulations coming into force, for approval.

(viii) *Limit on reinsurance*. Surplus over and above the domestic reinsurance arrangements class-wise can be placed by the insurer independently with any of the reinsurers subject to a limit of 10% of the total reinsurance premium ceded outside India being placed with anyone reinsurer. Where it is necessary in respect of specialised insurance to cede a share exceeding such limit to any particular reinsurer,

the insurer may seek the specific approval of the Authority giving reasons for such cession.

(B) Inward Reinsurance Business

Every insurer wanting to write inward reinsurance business shall have a well defined underwriting policy for underwriting inward reinsurance business. The insurer shall file with the Authority a note on its underwriting policy stating the classes of business, geographical scope, underwriting limits and profit objective. The insurer shall also file any changes to the note as and when a change in underwriting policy is made.

IRDA (APPOINTED ACTUARY) REGULATION, 2000

IRDA Regulations, 2000 in respect of an appointed actuary require every insurer, registered to carryon insurance business in India, to appoint an actuary, who shall be known as the' Appointed Actuary' for the purposes of the Act.

Eligibility

A person shall be eligible to be appointed as an appointed actuary for an insurer, if he or she shall be- .

(i) ordinary resident in India
(ii) a Fellow Member of the Actuarial Society of India;
(iii) an employee of the life insurer, in case of life insurance business;
(iv) an employee of the insurer or a consulting actuary, in case of general insurance business; .
(iv a) a person who has not committed any breach of professional conduct;
(v) a person against whom no disciplinary action by the Actuarial Society of India or any other actuarial professional body is pending;
(vi) not an appointed actuary of another insurer; .
(vii) a person who possesses a Certificate of Practice issued by the Actuarial Society of India; and
(viii) not over the age of seventy years.

Approval from Authority

An insurer shall seek the approval of the Authority for the appointment of appointed actuary, submitting the application in Form IRDA-AA-I. The Authority shall, within thirty days from the date of receipt of application, either accept or reject the same. If an insurer does not receive approval within 30 days of the receipt of such application by the authority, the insurer shall deem that the approval has been granted by" the authority.

Powers of Actuary Appointed

An appointed acturary shall have the following powers.

(i) access to all information or documents in possession or under control of insurer;
(ii) seek any information from any officer or employee of the insurer;
(iii) to attend all meetings of the management;
(iv) to speak and discuss on any matter;
(v) to attend any meeting of the shareholders or the policy holders of the insurer.

General duties and obligations

Duties and obligation of the Appointed Actuary include:

(i) rendering actuarial advice to the management of the insurer, in particular in the areas of product design and pricing, insurance contract wording, investments and re-insurance ; .
(ii) ensuring the solvency of the insurer at all times;
(iii) certification of assets and liabilities that have been valued;
(iv) maintenance of required solvency margin;
(v) ensuring that provisions of the Act have been complied with and nothing is in contravention of the act or against the interest of the policy holders;
(vi) complying with Authority's directions from time to time.

Duties of the insurer carrying on life insurance business

(a) certify the acturial report and abstract;
(b) recommend interim bonus or bonuses payable by life insurer to policy holders whose policies mature for payment by reason of death or otherwise,
(c) to ensure that all requisite records required for actuarial valuation have been obtained by him;
(d) ensure that premium rates of the insurance products are fair;
(e) to certify that mathematical reserves have been determined on the basis of guidance notes issued by Actuarial Society of India;
(f) to submit actuarial advice in the interests of insurance industry and the policy holders.

Duties of insurer carrying on general insurance business

Appointed actuary is to perform the following duties in the case of the insurer carrying on general insurance business. He is to ensure

(i) that the rates are fair in respect of those contracts that are governed by the insurer's in-house tariff;
(ii) that the actuarial principles, in the determination of liabilities have been used in the calculation of reserves for incurred but not reported claims (IBNR) and other reserves where actuarial advice is sought by the Authority.

IRDA (PROTECTION OF POLICY HOLDERS' INTERESTS) REGULATIONS, 2002

IRDA (Protection of Policyholders Interest Regulations) 2002 establish benchmarks in the quality of sales as well as service in life insurance and requires that every employee and agent in the organisation is fully aware of the regulations as well as their implications. Some of the important regulations are discussed below.

1. Prospectus to contain details of insurance product. A prospectus of any insurance product shall clearly state
    - the scope of benefits
    - the extent of insurance cover
    - conditions of insurance cover

- whether the product is participating (with profits) or non-participating the rider or riders attached to a life policy.

In no case, the premium relatable to all the riders put together shall exceed 30 % of the premium of the main product.

2. Information to the prospect. An insurer or its agents shall provide all material information in respect of a proposed insurance product to the prospect and advise him dispassionately. He should get the form signed from the prospect that he has fully understood the significance of the proposed product.
3. Agents to follow code of conduct. The regulations require the insurer or the agent to follow, the code of conduct prescribed by the Authority. the councils. the recognised professional body or association of which he is a member, in the process of sale.
4. Proposal to be accepted on proposal form. A proposal for the grant of a cover either for life business or for general business must be evidenced by a written document except in case of marine insurance cover. It is the duty of an insurer to furnish to the insured free of charge, within 30 days of the acceptance of a proposal a copy of the proposal form.
5. Onus of proof lies with insurer. Where a proposal form is not used, the insurer shall record the information obtained orally or in writing and confirm it within a period of 15 days there of with the proposer and incorporate the information in its cover note or policy. The onus of proof shall rest with the insurer in respect of any information not so recorded, where the insurer claims that the proposer suppressed any material information or provided misleading or wrong information on any matter material to the grant of a cover.
6. Processing with speed and efficiency. Proposal shall be processed by the insurer with speed and efficiency and all decisions there of shall be communicated by it in writing within a seasonal period not exceeding 15 days from receipt of proposals by the insurer.
7. Grievance redressal procedure. Every insurer shall have in place proper procedures and effective mechanism to address complaints and grievances of policy-holders efficiently and with speed.
8. Matters to be stated in life insurance policy.
   (a) A life insurance policy shall clearly state:
      (i) the name of the plan governing the policy, its terms and conditions;
      (ii) whether it is participating in profits or not;
      (iii) the basis of participation in profits such as cash bonus, deferred bonus, simple or compound reversionary bonus,
      (iv) the benefits payable and the contingencies upon which these are payable and other terms and conditions of the insurance contract;
      (v) the details of the riders attaching to the main policy (vi) the date of commencement of risk and the date of maturity of date (s) on which the benefits are payable.
      (vii) the premiums payable, periodicity of payment, grace period allowed, the date of last installment.
      (viii) the age at entry and whether the same has been admitted.
      (ix) the policy requirements for conversion of the policy into paid up policy, surrender, non-feiture, and revival of lapsed policies.

(x) the provisions for nomination, assignment, loans on security of the policy

(xi) the documents that are required to be submitted by a claimant in support of a claim under the policy.

(b) the insurer shall inform by letter forwarding the policy that he has a period of 15 days from the date of receipt of the policy document to review the terms and conditions of the policy and where the insured disagrees to any of those terms and conditions he has the option to return the policy. The insured, then shall be entitled to refund of the premium paid.

9. Matters to be stated in general insurance policy.

(a) A general insurance policy shall clearly state:

(i) the names(s) and address(es) of the insured and of any bank (s) or any other person having financial interest in the subject matter of insurance;

(ii) full description of the property or interest insured

(iii) sum insured;

(iv) period of insurance;

(v) perils covered and not covered;

(vi) premium payable;

(vii) policy terms, conditions and warranties;

(viii) action to be taken by the insured upon occurrence of a contingency likely to give rise to a claim under the policy

(ix) the obligations of the insured

(x) provision for cancellation of the policy on grounds of mis-representation, fraud, non-disclosure of material facts or non cooperation of the insured.

(xi) the details of the riders attached to the main policy.

(b) Every insurer shall inform and keep informed periodically the insured on the requirements to be fulfilled by the insured regarding loading of a claim. Claims procedure in respect of life insurance policy

(i) A life insurance company, upon receiving a claim, shall process the claim without delay. Any queries or requirement of addition, documents, to the extent possible, shall be raised all at once and not in piece meals with in a period of 15 days of the receipt of the claim.

(ii) A claim under a life policy shall be paid or be disputed giving all the relevant reasons, with in 30 days from the date of receipt of all relevant papers and clarifications required. Where an investigation is required, the company shall initiate it not later than 6 months from the time of lodging the claim.

(iii) Where a claim is ready for payment but the payment can not be made due to proper identity of the payee, the life insurer shall hold the amount for the benefit of the payee

(iv) Where there is a delay on the part of the insurer in processing the claim, the life insurance company shall pay interest on the claim amount at a rate, which is 2 % above the bank rate prevalent at the beginning of the financial year in which the claim is reviewed by it.

Claim procedure in respect of a general insurance policy

(i) An insured or the claimant shall give notice to the insurer of any loss arising under contract of insurance at the earliest or within such extended time as maybe allowed by the insurer. The company shall appoint a surveyor for assessing the loss/claim with in 72 hours of the receipt of intimation from the insured.

(ii) The surveyor has to follow the code of conduct laid down by the authority while assessing the loss and shall submit his report with in 30 days of his appointment. A copy of report shall also be furnished to the insured. .

(iii) If the survey report submitted by surveyor is found to be incomplete regarding certain specific issues, then the insurer may request to submit an additional report on such issues within 15 days of the receipt of the original survey report.

(iv) The surveyor shall submit an additional report within 3 weeks of the date of receipt of intimation from the insurer.

(v) An insurer shall within a period of 30 days of receiving the reports offer a settlement of the claim to the insured.

(vi) Upon acceptance of an offer of settlement by the insured the payment of the amount due shall be made within 7 days from the date of acceptance of the offer by the insured. Delay in the payment imposes penalty on the insurer at a rate of 2 % above the bank rate of interest.

DUTIES, POWERS AND FUNCTIONS OF AUTHORITY

The IRDA Act lays down the duties, powers and functions of the Authority. These are given in section 14 of the Act, which runs as follows:

1. Subject to the provision of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure
2. Without prejudice to the generality of the provisions contained in sub-section (1) the powers and functions of the Authority shall include

(a) issue to the applicant a certificate of registration, renew, modify withdraw, suspend or cancel such registration;

(b) protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest. settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

(c) specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents:

(d) specifying the code of conduct for surveyors and loss assessors;

(e) promoting efficiency in the conduct of insurance business;

(f) promoting and regulating professional organisations connected with the insurance and re-insurance business;

(g) levying fees and other charges for carrying out the purposes of this Act;

(h) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers intermediaries, insurance intermediaries and other organisations connected with the insurance business;

(i) control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so

controlled and regulated by the Tariff Advisory Committee under section 64 U of the Insurance Act, 1938 (4 of 1938);

(j) specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

(k) regulating investment of funds by insurance companies:

(l) regulating maintenance of margin of solvency;

(m) adjudication of disputes between insurers and intermediaries or insurance intermediaries;

(n) supervising the functioning of the Tariff Advisory Committee:

(o) specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organizations referred to in clause (j);

(p) specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and

(q) exercising such other powers as may be prescribed.

In view of the duties assigned to it and powers given under the Act. The Authority has notified number of regulations to discharge of its function. These notifications have been discussed earlier.

FINANCE ACCOUNTS AND AUDIT

The provisions regarding Finance, Accounts and Audit are contained in chapter V of the Act. The main provisions are

1. *Grants by Central Government* The Central Government may after due appropriation made by Parliament by law in this behalf, make to the Authority grants of such sums of money as the Government may think fit for being utilised for the purposes of this Act.

Thus, the grants from the Central Govt. are one of the main sources of funds for the Authority at least to begin with.

2. *Constitution of Funds* There shall be constituted a fund to be called "the Insurance Regulatory and Development Authority Fund" and there shall be credited thereto

(a) all Government grants, fees and charges received by the Authority;

(b) all sums received by the Authority from such other source as may be decided upon the Central Government;

(c) the percentage of prescribed premium income received from the insurer. "

3. *Application of Fund* The Fund shall be applied for meeting

(a) the salaries, allowances and other remuneration of the members, officers and other employees of the Authority;

(b) the other expenses of the Authority in connection with the discharge of its functions and for the purposes of this Act.

4. *Accounts*. The Authority shall maintain proper accounts and other relevant records and prepare an annual statement of accounts in such form as may be prescribed by the Central Government in consultation with the Comptroller and Auditor-General of India. .

5. *Audit*. (1) The accounts of the Authority shall be audited by the Comptroller and Auditor-General of India at such intervals as may be specified by him and any expenditure incurred in connection with such audit shall be payable by the Authority to the Comptroller and Auditor- General.

(2) The Comptroller and Auditor-General of India and any other person appointed by him in connection. with the audit of the accounts of the Authority shall have the same rights, privileges and authority in connection with such audit as the Comptroller and Auditor-General generally has in connection with the audit of the Government accounts and, in particular, shall have the right to demand the production of books of account, connected vouchers and other documents and papers and to inspect any of the offices of the Authority.

(3) The accounts of the Authority as certified by the Comptroller and Auditor-General of India or any other person appointed by him in this behalf together with the audit-report thereon shall be forwarded annually to the Central Government and that Government shall cause the same to be laid before each House of Parliament.

POWERS OF CENTRAL GOVT TO ISSUE DIRECTIONS

Section 18 of the Act given in chapter VI lays down the Powers of the Central Govt to issue directions as follows:

(1) Without prejudice to the foregoing provisions of this Act, the Authority shall, in exercise of its powers or the performance of its functions under this Act, be bound by such directions on questions of policy, other than those relating to technical and administrative matters, as the Central Government may give in writing to it from time to time:

Provided that the Authority shall, as far as practicable; be given an opportunity to express its views before any direction is .given under tl~is sub-section.

(2) The decision of the Central Government, whether a question is one ;of policy or not, shall be final.

LESSON 24
INSURANCE SERVICES: POSITION IN INDIA, PRIVATE INSURANCE COMPANIES IN INDIA

Lesson Objectives: **To know the position of insurance services in India,**
To understand operations of private insurance companies in India.

INTRODUCTION

We all are exposed to various risks in our daily life. Even the wisest and cleverest person cannot provide for or avoid all risks. Nobody can predict or foresee the calamity he may suffer in future. Everybody on the road, whether on foot or in a vehicle carries some risk of accident which may result into serious injury, loss of limb impairing ability to earn livelihood, or even death. One may take precautions against such risk, but the risk cannot be eliminated. Similarly, there can be loss due to fire, floods, earthquakes, burglaries, illness etc. Every loss causes human suffering.

It is possible to take precautions against such even/s, but the possibility of such happenings cannot be completely ruled out. One can also make provision for coping up with such events, but cannot eliminate the chance of such happening. For example, security can be increased in a particular area in view of increased burglaries, however, burglary can still happen. One can increase life expectancy by proper health and medical care, however death will still happen. Efficient fire service can minimise the loss due to fire but cannot prevent the occurrence of fire. In short, risks can be reduced but not eliminated.

A risk involves loss. Not all, but most of the losses can be expressed in terms of money. A person exposed to some risk may incur a loss. If loss is small he may bear it alone. If loss is huge he may not be able to bear it alone. Society may have to render help to enable the sufferer to cope up with the situation. Example, the help rendered to the victims of earthquake in Gujarat. However, it will be better if a device or system is developed to provide help to those who happen to suffer a loss. Such a device is 'insurance'.

Insurance is a co-operative device, which spreads, the loss caused by a particular risk to some persons, over a number of persons who are exposed to, same or similar risk and who agree to 'insure' against that risk.

DEFINITION

There can be two approaches for defining insurance. One is functional approach other is contractual approach.

Functional Definitions

The functional approach definitions discussed below are note worthy. According to Encyclopaedia Britannica, "Insurance may be defined as a social device whereby a large group of individuals, through a system of equitable contributions, may reduce or eliminate measurable risk of economic loss common to all members of the group." In similar sense Disnadle has defined that, "Insurance is an instrument of distributing the loss of few among many." Allen.

C. Mayerson states that, "Insurance is device for the transfer to an insured of certain risks of economic loss that would otherwise be borne by the insured."

From the above definitions, it emerges clearly that the functional definition has the following features:

- it is a co-operative device,
- it spreads the risk over a large number of persons who are insured against the risk,
- it provides security to the insured.

Contractual Definitions

In contractual sense the following definitions are noteworthy. According to Justice Tidal, "Insurance is a contrast in which a sum of money is paid to the assured in consideration of insurer'~ incurring the risk of paying a large sum upon a given contingency." In the words of E. W. Patterson, "Insurance is a contract by which one party, for a consideration called premium, assumes a particular risk of the other party and promises to pay to him or his nominee a certain or ascertainable sum of amount on a specified contingency." The contractual approach definitions highlight the following features:

- It is a contract,
- Where by insurer assumes the risk of insured,
- And promises to pay a specified or ascertainable amount,
- On the happening of a specific event,
- In consideration of the premium paid by the insured,
- The person who seeks protection against a risk is known as 'insured'. The person who provides protection is 'insurer' (i.e. insurance company). The document containing terms and conditions of contract in called 'policy' or 'insurance policy'. The consideration from the insured' is called premium.

PRINCIPLES OF INSURANCE .

Like definition of insurance two approaches can be followed for principles

Basic Principles

The concept of insurance is based on two basic principles:

(a) *Principle of Co-operation*: Insurance can be described as highest degree of Co-operation. The insurance company or insurer collects premium from large number of insured persons and puts the premium in pool. The claims of those who actually suffer loss are paid out of the pool. The insured are cooperating by paying premium in advance to strengthen the pool.

(b) *Principle of Probability:* Without premium, co- operation is not possible and premium can not be determined without applying theory of probability. The occurrence of risk in each type of insurance can be estimated with the help of theory of probability. The probability tells about the chances and amount of loss. The theory or inertia of large numbers is applied for calculating the probability. The companies collect the data of previous happenings over a large number of years to form an idea about the probability of incidence in future. Similarly, life insurance companies prepare and use the mortality table to determine the premium.

Legal Principles

Legal principles, with the exception of principle 0(, indemnity which is not applicable in case of personal insurance, are common for all types of insurance. These principles are discussed below.

(i) Principle of Uberrimae Fedai (utmost good faith): Contracts of insurance are based on mutual trust and faith. It is a contract which requires Uberrimae Fedai i.e. utmost good faith. In accordance with this principle, the insured must make full disclosures regarding the material facts. The material facts in such contracts are those, which are rein event for the insurer to evaluate the risk of the insured e.g. nature of the risk and character of the insured.

However, there is no obligation to disclose which are of public knowledge, do not increase, are contained in the documents, cannot be noticed in survey etc. A non-disclosure, concealment, mis-representation, or fraudulent representation will make the contract either void or voidable at the option of the insured.

(ii) Principle of Insurable Interest: In a contract of insurance the insured must possess an insurable interest in the subject matter. In other words, he should have an interest in the non-happening of the contingency or event causing the loss. His relationship with the subject matter is such that he suffers loss or damage, if contingency happens and is benefited if it does not happen. It is pecuniary or monetary in nature and only emotional. The insurable must be recognised so by the law of the country concerned. It should normally satisfy the following conditions:

1. There must be a subject matter (e.g. goods, liability) etc.;
2. Subject matter must be exposed to some risk;
3. The insured must have a legally recognised relationship or interest in the subject matter,
4. The insured should have beneficial interest in the safety of the subject matter, or the non-happening of the risk event,
5. The risk or loss should be measurable in terms of money (except life insurance),
6. The point of time when insurable interest should be in existence differs with the kind of insurance. The position is as follows:

Life insurance: Insurable interest must exist at the time of entering into insurance contract.

Marine insurance: It must exist at the time of loss.
Fire insurance: It must exist at the time of entering into contract as well as at the time of loss.

(iii) Principle of Indemnity: The principle is applicable in non-life insurance 'only. The loss due to loss of a life cannot be measured in terms of money. Therefore, there has to be a prior agreement regarding amount. However, in non-life insurance the principle of indemnity is very important as it determines the quantum of liability.

Indemnity, in simple words is promise to compensate the loss. This principle ensures that the insured is indemnified' to the extent he suffers loss, but he should not make any profit out of the event. Thus, if a fire insurance policy for goods is taken up

for Rs. 2,00,000, but the actual loss in the incidence of fire is Rs. 50,000 only the insurer can be called upon to pay the actual loss suffered i.e. Rs. 50,000 and not the policy amount of Rs. 2,00,000. In simple words:

- There must be actual loss;
- The loss should have occurred from the risk insured;
- The loss should be measurable in terms of money.
- The compensation can not exceed the actual loss;
- The compensation will be paid by the insurer.

(iv) Principle of Causa Proxima: The prWCIple of 'causa proxima' lays down that the proximate cause (nearest cause) is to be the basis of determining the liability of the insurer and not the remote cause. Thus, where immediate cause of the loss is insured risk, the insured will be indemnified for the loss. The remote cause is not to be taken into consideration. Thus, where fire is caused by short- circuiting destroying the godown. The fire insurance amount will be paid as fire is the proximate cause of loss. The insurer can not escape liability by pleading that the loss is caused by short circuiting which is not ensured risk. Short circuiting is the remote cause, fire is the proximate cause. In other words, when the insured risk is not the proximate cause of loss no compensation will be paid.

(v) Principle of Subrogation: Principle of subrogation supplements the principle of indemnity. Subrogation means stepping into shoes of another. In simple words it means inheriting the right available to an individual. Once the insurer compensates the insured for the loss suffered by him, he will inherit all the rights available to the insured against the third parties with regard to the subject matter of the insurance. Subrogation means:

- the insurer compensates the insured for the actual loss;
- having compensated the insured, he steps into his shoes to claim his rights against the concerned third parties;
- however, if he gets more than the compensation given to the insured, the surplus will have to be given to the insured and the insurer can not retain it;

Like principle of indemnity, it is not applicable to personal insurance.

(vi) Principle of Contribution. Principle of contribution also is an off shoot of the principle of indemnity. When the insured has taken more than one policy for the same subject matter against the same risk during the same period, the liability of insurers will be determined on pro-rata basis. Principle of contribution gives right to an insurer, who has fully compensated the insured, to seek pro-rata contribution from the other insurers. However,

1. all the policies must relate to the same period;
2. the subject matter must be the same;
3. the protection sought must be against the same risk;
4. policies must be in force at the time of loss;
5. the insured must be the same.

Being off-shoot of the principle of indemnity, this principle also is not applicable to personal insurance.

KINDS OF INSURANCE

Insurance can be mainly classified into two categories.

1. Life Insurance

The subject matter of this type of insurance is human life. Most of the insurance policies are combination of savings and security. The insured is promised by the insurance company that during the tenure of insurance in case of his death, his nominee will be paid the insurance amount According to section 2(ii) of Insurance Act 1938, "Life insurance is the business of effecting contracts of insurance upon human life including any contract, whereby the payment of money is assured on death except death by accident on the happening of any contingency dependent on human life and any contract which is subject to the payment of premium for a term dependent on human life. In case he survives the term of the policy, he will be paid an amount as per terms of the policy.

2. General Insurance

All other types of insurance are called general insurance or non- life insurance. The common type of general insurances are discussed below:

(a) Marine Insurance. It is oldest type of insurance. It covers the sea or marine perils. Peril is the cause of loss or hazard which is a condition that may increase the chance of the loss. Marine insurance is protection against marine perils like loss or sinking of the ship, sea piracy, capture by enemy etc. The loss could be of ship, cargo or freight. Marine insurance will cover such risks.

(b) Fire Insurance. It covers the loss due to fire to the property like houses, shops, goods factories or god own etc. It covers loss from fire and the consequent loss from such fire i.e. the loss of work due to stoppage of work due to fire.

(c) Liability Insurance. This type of insurance covers the risk of liability against third parties, which an insurer might have to pay under certain circumstances. For example, injury to the property and/or person of a third person in road accident or employer's liability for an injury or death ot a worker while performing duty etc.

(d) Social Insurance. This insurance: is aimed at providing social security to the weaker sections of the society. It may take the shape of pension plans, disability or sickness benefits etc. The premium may come from Govt. or employee and may also be shared by beneficiary.

(e) Other Insurances. All other type of general insurances can be placed under this category e.g. theft insurance, earthquake insurance, flood insurance, crop insurance, personal accident insurance, cattle insurance or livestock insurance, guarantee insurance etc.

Certain other types of insurance, one may come across are:

(i) Double Insurance. It implies that the subject matter of insurance has been insured with two or more insurers or with the same insurer under more than one policy. In case of life insurance, all the amounts can be claimed separately, if the need arises.

However, general insurance is contract of indemnity, where the maximum amount payable by the insurer can not exceed the actual amount of loss. Thus, even if one covers through different policies with same or different insurers, he can not recover more than the loss incurred, which is to be contributed on prorate basis by different insurers. Thus, here is no benefit to the insured due to any over insurance.

(ii) Reinsurance. Reinsurance is insurance of a part of the risk insured by an insurer with no other insurer. The concept of insurance is based on spreading of risk. Someti es an insurance company may get a profitable opportunity to insure a huge rperty. In the process it can expose itself to a major risk, which it may not be in a position to bear. In such a situation it can resort to reinsurance with other companies. Thus a part of the risk gets transferred to other companies.
Therefore, in this situation there are two contracts for the same subject matter. The first one is a direct insurance between direct insurer and the insured. The second one is between insurer and other insurers as now the insurer has acquired insurable interest in the same subject matter.

(iii) Over insurance. When the total insurance taken under one or more policies is more than the value of the subject matter. It is called over insurance. The over insurance is not at all advantageous as under the principle of indemnity, only the actual loss will be compensated.

(iv) Underinsurance When the total insurance undertaken under a policy or policies is less than the value of the subject matter, the situation is called under insurance. The insurance companies, in such case, penalize the insured by invoking the 'average clause' of the policy. Under this the claim payable by the insurance company is in proportion of the insured sum and the value of the subject matter. Is there any distinction between Insurance and Assurance?

In the literature of insurance one comes across two terms i.e. insurance and assurance. These two terms are used interchangeably in the market. Technically, there is no difference between the two terms.
However, if one tries to make distinction between the two, following distinctions can be made out:

- the term 'assurance' should be used for life contract and 'insurance' for general insurance or contracts of indemnity (but in India the terms have been used just the opposite way)
- when the risk is certain but time of occurrence is not known, it may be called assurance (e.g. life insurance). When risk is probable and uncertain term insurance may be used,
- 'Insurance' means 'indemnity' assurance means loss can not be estimated,
- In assurance, claim is certain, in insurance claim is uncertain,
- Assurance is the principle and insurance is the practice,

  However, technically and in practice there is no difference between two terms.

RATIONALE FOR OPENING UP OF INSURANCE SECTOR TO THE PRIVATE "SECTOR

After banking, insurance is the most important segment of the financial sector, capable of providing huge funds for the economic development of the economy. The

stakes involved called for regulation of this important sector by the state in one form or the other. The first important step in this direction was in 1928, when Indian Insurance Companies Act, was enacted. This enabled the Govt. to put together information regarding life and non-life insurance business. At that time both Indian and foreign insurers were in the business. The Act was amended completely in 1938.
In 1956, the management of all 245 Indian and foreign insurers was taken over by the Govt. of India and thereafter, the business was nationalised and Life Insurance Corporation of India was set up. In 1972, one hundred and seven Indian and foreign general insurance companies were merged into four companies. The general insurance business was nationalised and the four companies were made subsidiaries of General Insurance Corporation of India.
Malhotra Committee

In the beginning of 1990's, Government of India, in the light of the developments in the rest of the world decided to globalise Indian economy. The policy involved deregulation and privitisation of sector which were controlled by the Government While for the banking sector Narsimaham Committee was appointed, a committee under the Chairmanship of Mr. R.N. Malhotra, former Governor RBI was set up for the insurance sector. The genesis of opening up of the Indian insurance sector to the private sector lies in the recommendation of Malhotra Committee. The Committee was to examine the issues of

- increasing the search of insurance industry
- improving the customer service. The Committee was of the opinion that these objectives can be achieved through privatisation of the sector or by allowing participation of the private sector companies.

Following are the grounds on the basis of which the opening up of the insurance sector to private sector can be justified:

- Size of the Market. The potential market is estimated at 312 million people. Some estimates suggest that only 25 percent insurable population has taken up the insurance policies. According to National Council for Applied Research, 50 million people have the capacity to pay an annual premium of Rs. 10,000, 100 million have the capacity to pay annual premiums of Rs. 7,000 and another 50 million have the capacity to pay Rs. 3,500 per annum. Thus, there is a huge market to be tapped.
- Enough for All Companies. There is no reason for LIC & GIC to worry about their future. There is enough market for everyone to work upon. Each has to create their own place in the insurance market.
- Low Penetration Ratio. The penetration ratio is extremely low in India. Per Capita insurance premium in India, in 1999, was $ 8 only as against $ 4,800 in Japan. In the year before that the per capita long term insurance was estimated at $ 5 (Rs. 202) only. The life insurance premium was only 1.4 percent of GDP. The penetration of non-life business is still lower at Rs. 81.26 or 0.56 per cent of GDP. LIC and GIC have been able to tap only 10 per cent of the market and 90 per cent of the market is still untapped.
- Growth in Economy & Insurance Business. The economy has grown at the rate of 5.6 per cent per annum during 1990's. The gross domestic savings are around 25 per cent, which has the potential to grow to 45 per cent. The Insurance business life and non life has been showing growth rate of 17 and

12 percent respectively. Therefore, there is need to have more players in the field.

- Good Prospects for Rural & Social Sector. The IRDA through its notification has ensured that the insurers do not ignore the rural and social sectors. Since, they have statutory obligation to do business in these sectors. the two sectors will get benefit.
- Funds for Development of Economy. Insurance funds are a good source for longterm needs of funds in an economy. The untapped market has great potential for providing funds for the long term projects, particularly, in the infrastructure.
- The Regulatory Framework. The insurance sector was opened by the Government in 1998. The requisite regulatory framework, has been put in place by IRDA, through various notifications. The IRDA and advisory committee have started functioning, therefore, the private sector will work according to the guidelines given to them.
- More Products Required. With the large potential customer base, it is required that the products tailor made for requirement of customers should be introduced. This will be possible only when, there will be, competition in the market.
- Employment Generation. When the economies grow, the contribution of the services to the GDP increases. This trend has also been observed in India. There is great potential of growth in employment through insurance and insurance related 'services. As a result of the opening up of the sector, the following insurers have already registered with IRDA:

  Life Insurance
  - LIC of India
  - HDFC Standard Life Insurance Company Ltd.
  - Max New York Life Insurance Company Ltd.
  - ICICI Prudential Life Insurance Company Ltd.
  - Om Kotak Mahindra Life Insurance Company Ltd.
  - Birla Sun Life Insurance Company Limited.
  - Reliance Life Insurance Company Ltd.
  - Tata AIG Life Insurance Company Ltd.
  - SRI Life Insurance Company Ltd.

  General Insurance
  - New India Assurance Company Ltd.
  - United India Assurance Company Ltd.
  - Nationai Insurance Company Ltd.
  - Oriental Insurance Company Ltd.
  - Royal Sundaram Alliance Insurance Ltd.
  - Reliance General Insurance Company Ltd.

INSURANCE POLICIES

Like any other contract, a contract of insurance must be clear and not vague or ambiguous. Therefore, the various terms and conditions of contract between 'the

insurer' and 'the insured' need to be determined and laid down clearly to minimise the chances of dispute. These terms and conditions are laid down in a document, known as 'policy'. The insurance policies are divided into two broad categories:

1. Life insurance policies.
2. General Insurance i.e. Marine, fire and accident insurance policies.

Before the opening up to private sector, insurance business was being carried out by LIC and GIC only. But with the coming of IRDA Act, insurance sector has been opened up to private sector and many private companies are already into the field selling insurance services / products.

INSURANCE AND INDIA

Summary

Despite innumerable delays the sector has finally opened up for private competition. The threat of private players shaking and giving the run for incremental market share for the Public Sector mammoths has been overplayed. The number of potential buyers of insurance is certainly attractive but much of this population might not be accessible New insurers must segment the market carefully to arrive at the appropriate products and pricing. Since distribution will be a key determinant of success for all insurance companies regardless of age or ownership we can expect a total change of the distribution network. As the product move towards the mature stages of commodization (increased awareness and popularity) they could then a host of new channels like grocery stores, direct mails would emerge. . Regulators must formulate strong and fair guidelines and ensure that old and new players are subject to the same rules and at the same time the government should ensure that the IRA does not become yet another toothless tiger like CEA or TRAI.

Main Article

Insurance – On Threshold

The liberalization of the Indian insurance sector has been the subject of much heated debate for some years. The policy makers where in the catch 22 situation wherein for one they wanted competition, development and growth of this insurance sector which is extremely essential for channeling the investments in to the infrastructure sector. At the other end the policy makers had the fears that the insurance premia, which are substantial, would seep out of the country; and wanted to have a cautious approach of opening for foreign participation in the sector.

As one of the rare occurrences the entire debate was put on the back burner and the IRDA saw the day of the light thanks to the maturing polity emerging consensus among factions of different political parties. Though some changes and some restrictive clauses as regards to the foreign participation were included the IRDA has opened the doors for the private entry into insurance.

Whether the insurer is old or new, private or public, expanding the market will present multitude of challenges and opportunities. But the key issues, possible trends, opportunities and challenges that insurance sector will have still remains under the realms of the possibilities and speculation. What is the likely impact of opening up India’s insurance sector?

Broadening of Benefits

The large scale of operations, public sector bureaucracies and cumbersome procedures hampers nationalized insurers. Therefore, potential private entrants expect to score in the areas of customer service, speed and flexibility. They point out that their entry will mean better products and choice for the consumer. The critics counter that the benefit will be slim, because new players will concentrate on affluent, urban customers as foreign banks did until recently. This seems to be a logical strategy. Start-up costs-such as those of setting up a conventional distribution network-are large and high-end niches offer better returns. However, the middle-market segment too has great potential. Since insurance is a volumes game. Therefore, private insurers would be best served by a middle-market approach, targeting customer segments that are currently untapped.

Unrealistic - Fears

An often-voiced concern is that private players, especially foreign ones, will swamp the market, grabbing a large share. A similar threat was overplayed in the case of basic telephone services and when the private players started their operations the dominance and might of DoT has remain unaltered. This hypothesis that the private players would swamp the market has been disproved in many emerging markets worldwide not only in case of the insurance but in numerous different sectors (Power, Energy, Telecom, Insurance etc.).

Yet, multinational insurers are keenly interested in emerging insurance because their home markets are saturated while emerging countries have low insurance penetrations and high growth rates. International insurers often derive a significant part of their business from multinational operations. As early as 1994, many of the UK's largest life and general insurers derived 40% to 60% of their total premia from outside their home markets. Though the global operations of the multinational insurers have an immense impact on their typically foreign insurers take only a small share of an individual country's market. For example in Taiwan the foreign companies took only a 3% share even seven years after opening up while in Korea, their share was barely 1% after 20 years. Moreover India is a large, quite diverse and complex market thus private insurers will have to learn and unlearn quite a few things before they can make any headway to grab the market share. Yet for the new entrants this small share of a large and growing market can be profitable.

Untapped Opportunities

There is no doubt that the potential market for the buyers of insurance is significant in India and offers a great scope of growth. First, while estimating the potential of the Indian insurance market we often tempt to look at it from the perspective of macro-economic variables such as the ratio of premium to GDP which is indeed comparatively low in India. For example, India's life insurance premium as a percentage of GDP is 1.3% against 5.2% in the US, 6.5% in the UK or 8% in South Korea. But the fact is that the large part of the India's, (the number of potential buyers of insurance) is certainly attractive. However, this ignores the difficulties of approaching this population. New entrants in other mass industries such as consumer products or retail banking have discovered this after burning their fingers. Much of

the demand may not be accessible because of poor distribution, large distances or high costs relative to returns.

Secondly most new entrants have a tendency to target the business of existing companies rather than expanding the market, this is myopic. This not only leads to intense competition for the new players and their much of their efforts is spent on trying to capture existing customers by offering better service or other advantages. Yet, the benefits of this strategy are likely to be limited. For example, 50% of the current demand for general insurance comes from the corporate segment. The corporates are likely to shop around for the best rates, products and service. Nevertheless, the corporate segment, as a whole will not be a big growth area for new entrants. This is because penetration is already good, companies receive good service because of their size and rates are tariff-governed. In both volumes and profitability therefore, the scope for expansion is modest. A better approach may be to examine specific niches where demand can be met or stimulated.

Key - Innovation & Variety of Products

The new entrants would be best served by micro-level two pronged strategies. First, is to introduce innovative products offering a right mix of flexibility/risk/return depending which will suit the appetite of the customers and the secondly they would target specific niches, which are poorly served or are not served at all

The first prong of a new insurer's strategy could be to stimulate demand in areas that are currently not served at all. For example, Indian general insurance focuses on the manufacturing segment. However, the services sector is taking a large and growing share of India's GDP This offers immense opportunities for expansion opportunities. For example, revenue from remote processing activities in information technology is estimated at USD 50 billion in the next ten years. Insurers could respond with various liability covers.

Being the agrarian economy again there are immense opportunities for the new entrants to provide the liability and risks associated in this sector like weather insurance, rainfall insurance, cyclone insurance, crop insurance etc.

Next, the financial sector is aggressively targeting retail investors. Housing finance, auto finance, credit cards and consumer loans all offer an opportunity for insurance companies to introduce new products like creditor insurance etc. Similarly, organized sector sales of TVs, refrigerators, washing machines and audio systems in 1998 was around Rs.110 billion. Only a negligible portion of these purchases was insured. Potential buyers for most of this insurance lie in the middle class. Existing players can also profitably exploit these areas.

In case there are products, which are not serving adequately new products many of them, which are already prevalent in different markets can be customized to the Indian markets and used to expand the markets. For example life insurance products provide a good example. Life Insurance products have to compete with savings and mutual funds hence should offer various dimensions of risk/return/flexibility so they can be linked to stock market indices, inflation etc. making them more competitive and appropriate risk/return appetite for different investors at present there are no such products. Similar problems apply to pensions. For instance, pure protection products like term assurance account for up to 20% of

policies sold in developed countries. In India, the figure is less than one percent because policies are inflexible. They compete with investment and savings options like mutual funds. It is imperative that they should offer comparable returns and flexibility and there is immense scope of developing pure insurance products with flexibility.

The lack of a comprehensive social security system combined with a willingness to save means that Indian demand for pension products will be large. However, current penetration is poor. Making pension products into attractive saving instruments would require only simple innovations already prevalent in other markets. For example, their returns might be tied to index-linked funds or a specific basket of equities. Buyers could be allowed to switch funds before the annuities begin and to invest different amounts at different times

Health insurance is another segment with great potential because existing Indian products are insufficient. By the end of the GIC's Mediclaim scheme covered only 2.5 million people. Indian products do not cover disability arising out of illness or disability for over 100 weeks due to accident. Neither do they cover a potential loss of earnings through disability

Distribution – A Paradigm Shift

Since distribution will be a key determinant of success for all insurance companies regardless of age or ownership. The nationalized insurers currently have a large reach and presence. New entrants cannot-and does not-expect to supplant or duplicate such a network. Building a distribution network is expensive and time consuming. Yet, if insurers are to take advantage of India's large population and reach a profitable mass of customers, new distribution avenues and alliances will be imperative. This is also true for the nationalized corporations, which must find fresh avenues to reach existing and new customers. There would be substantial shifts in the distribution of insurance in India. Many of these changes will echo international trends. Worldwide, insurance products move along a continuum from pure service products to pure commodity products then they could be sold through the medical shops, groceries, novelty stores etc.. Once commodization, popularity and awareness of the products is attained then the products can move to remote channels such as the telephone or direct mail. In the UK for example, retailer Marks & Spencer now sells insurance products. At this point, buyers look for low price. Brand loyalty could shift from the insurer to the seller. Recognizing this trend, the financial services industry worldwide has success-fully used remote distribution channels such as the telephone or the Internet to reach more customers, cut out intermediaries, bring down overheads and increase profitability.

The Trinity of IT – Distribution - Training

Most of the opportunities and challenges that we have discussed apply equally to existing and new insurers. It must be emphasized that the opening of the insurance market is far from a bad thing for nationalized insurers. With a strong presence, a wide network and considerable brand equity, they are in a good position to tap the very same segments profitably, while improving their product and service offerings. All insurers in a liberalized Indian market will have to address a host of other issues. They will have to:

- Leverage information technology to service large numbers of customers efficiently and bring down overheads. Technology can complement or

supplement distribution channels cost-effectively. It can also help improve customer service levels considerably.

- Use data warehousing, management and mining to gauge the profitability and potential of various customer and product segments and ensure effective cross selling. Understanding the customer better will allow insurance companies to design appropriate products, determine pricing correctly and increase profitability.
- Ensure high levels of training and development not just for staff but for agents and distribution organisations. Existing organisations will have to train staff for better service and flexibility, while all companies will have to train employees to cope with new products and an intensive use of information technology.
- The importance of alliances and tie-ups means that companies will have to integrate related but separate providers into their systems to ensure seamless delivery.
- Build strong relationships with intermediaries such as agents.

Regulation – The Catalyst

Indian insurance is on the threshold of deep and fundamental changes. The life insurance industry was nationalized in 1956 and the general insurance industry in 1972. Before that India had a thriving and competitive insurance industry with hundreds of private and foreign operators. Indian companies held a 60% market share even then. Yet, insufficient regulation also meant that there were a number of abuses. In a reopened Indian insurance market, regulators must formulate strong fair and transparent guidelines and make sure that old and new players are subject to the same rules. Companies meanwhile must be prepared to set and meet high standards for themselves. The big challenge for both companies and regulators is to ensure that they replicate the benefits of the past while eliminating its ills

INSURANCE AS A PROMOTER OF SOCIAL AND ECONOMIC WELL-BEING

Preliminary

This subject is of much practical significance to all persons engaged in any form in insurance as a career. It reminds me of a quote from Alfred Adler. He says, "The only worthwhile achievements of man are those which are socially useful." In the rough and tumble of our workday world we should never lose sight of our goal to achieve a worthwhile and soul satisfying life. Insurance career has the potential to provide it for you.

It is sad but true that insurance is associated with disasters, calamity, and loss and suffering, large and small, which inflicts pain on industry, commerce, community or an individual person and/or his family. The very raison d'etre of insurance industry is to compensate the sufferer. Insurance comes into play only after there is some loss, sustained by somebody or some firm. It is a remedy. It seeks to restore the original position fully, or partly to the extent it can within the bounds of insurance contract entered into with the client.

The contribution insurance makes to the society is to lift the scene from a negative station to which it has been depressed by the risk undertaken to be protected having

materialized and brings it back to par. So, how can you say that it produces any positive effect? Does it really promote well-being?

By using funds the insurance has gathered and nurtured, out of insurance premium collected as fee for insurance service offered, he can and does help lift the economy, the Adam Smith way. Of course, the total resources required by economy are much too large in comparison with financial assets provided by insurance industry. Secondly, insurance is the latest happening. Few centuries back it was not there. In the Shakespeare's play 'The Merchant of Venice', Antonio, the celebrated merchant, tells us that ' my ventures are not in one bottom trusted, nor to one place nor is my whole estate, upon the fortunes of this present year' he knew well how to spread his risks but not how to transfer them to someone else's shoulder in exchange for a small fee, called insurance premium. For centuries, empires did rise, civilizations thrived, and commerce and trading was existent, current people lived, prospered, and died without the presence of insurance industry at their service. Compare electricity, which too arrived in late 19th century. You can manage without both insurance and electricity but will lose some quality of your life in bargain.

Well-being

Against the above canvass as a background painted here are a number of aspects which describes how the society and the economy today, derive the benefit of well being through the operation of the insurance industry which now is in our very midst and well entrenched at that.

The concept of well being is explained in the Webster dictionary as a state of being happy, healthy or prosperous, well to do. Another meaning is stated as welfare. The word welfare is itself defined as a state of being happy; and, secondly, as relief, aid of money or necessities for those in need. The word social welfare is somewhat different. It's meaning is given as assistance of disadvantaged groups through public or private social services.

Does insurance address any of these concepts? What does insurance actually do besides, of course, provide jobs for a few hundred thousand and dispensing dividend income to their shareholders? But remember we are not looking for material prosperity.

The magic of insurance

Insurance is defined as transfer of risk for a consideration. The clients have risks of various kinds and magnitudes. They divert their attention from their normal businesses. Secondly they do sometimes land him into monetary loss. By transferring his risk to insurers, clients free themselves from these anxieties and can devote full attention to their pursuits. But how does the insurer keep his cool accepting risk and the attendant losses that must be borne by him? The magic lies in estimating and correcting the chance of a risk actually materializing and then putting an appropriate price tag for that risk to meet the cost of insurance service and his profit margin.

The insurance firm at work

The insurer has two occupations to indulge in; he must sell and collect money from a large number of clients so that he gets average results. Where the number is not that large he had better transfer that risk to a reinsurer who generally operates worldwide and may gather enough numbers. If not, the reinsurer will decline and so will the insurer decline to accept that particular risk. Secondly the insurer does not know when the risk will befall. The timing is uncertain. So he will use the collected

premium fund/money for investment. Since it must be readily available when required to settle sudden claims from his clients he will not lock them up unwisely. There have to be assets and expected liability inflows to match. Further the money must be placed in safe outlets. He must also try to get the highest return subject to these required constraints of liquidity and safety. He has to quote competitive terms, so he must procure highest yield. He has also to declare adequate dividend so he can be certain of the capital market supporting him when he needs additional capital.

The need for capital arises because there is volatility in year-to-year results. If the chance of the loss incidence is 1 in 25 or 4%, it is small. But if I have invested my 20 lacs and these go in the air, it is no solace to me that there are 24 others whose 480 lacs worth funds are safe. The insurer may charge 6% or 1.2 lacs per annum as premium. I should prefer that to loosing 20 lacs in one go. The extra 2% is not completely the insurer's profit margin. There are the running expenses and infrastructure causes. But what about annual claims outgo? It would not be uniform every year.

Suppose 4% comes to 100, there being 2500 policy holders. Over 10 years the claims may be exact 1000, but the individual figures of the 10 years may be 75, 120, 40,140,65,200,80,90,110 and 80, say total 1000. The insurer must have funds to meet such volatility. That is he must have risked base capital. And when you have capital, it must be serviced. If the capital is not well serviced, in the event of need of further capital, the market will refuse or dictate harsh terms. Your issue manager will tell you what! If the capital is low it may even lead to the company being taken over by someone who has the money to pay and the desire to do so.

Thus from the time premium is collected to the time of incidence of the risk befalling the insurer the fund has to be used. When the claim arises the money passes from the insurer to the claimant, who will use it to recoup from the loss and get back to his earlier situation. It is in this way that economic well being is materialized through insurance. Well being, we know, is a state i.e. a mental state. But it will help the individual, the firm, or the community meeting their demands from life in a better, calm, collected way and enjoy doing so.

Types of insurance

Before we examine the social well being feature, we must learn about the three different types of insurance businesses. These are long term, short term and social insurance.

Life insurance and pension funds comprise long term insurance businesses. Their policy contracts are mostly long term with fixed premiums and certain benefits. They have to accumulate and husband their funds for long periods. They can therefore invest in long-term projects, support share markets and the issues floated by governments, infrastructure corporations and the like; and also housing finance.

Short term insurance covers risks on property and liability. They issue insurance contracts of indemnity from year to year. They keep large funds to meet larger volatility in their business and can finance on short-term basis only.

Health insurance contracts are of either type, short as well as long. Both life as well as non- life insurers transact this type of business each selling products that suit their province.

Social insurance is a class apart. The state shares a part of the premium with the insured person or where he is employed, with him and his employer. This insurance is of compulsory nature and is offered because most people are unable to afford price of insurance on their own. Depriving them totally or altogether from insurance, leads to privation and ultimately social costs. In developed economies the social insurance covers extends from birth through unemployment, sickness and lifelong pensions to right upto funeral expenses. It is provided at a low level. The government must afford it. The better off can add more insurance on their own by going to the insurance companies, if the benefits are inadequate for them.

Social well-being

"For ye have the poor always with you; but me ye have not always" told Jesus.

Those who are not covered by social insurance, the destitute, those who will not afford even the subsidized premium for social insurance are provided social assistance by the state. Absence of insurance to some others due to their negligence, even though affordable, pricks conscience. Suppose your neighbor did not provide life insurance or had it at marginal level. In the event of his untimely death how would you like to live as neighbors with his family? They are of course in distress and may remain so at least for some years; but you too cannot live in a happy frame of mind, especially during festivals. Suppose there are several industries - small and medium in a row or block in an industrial estate. There is a wild fire. One out of the affected industries had not taken fire insurance. The others get money, use it, and within a short time are back in business mostly to their normal. What about the one who is left out because of his own imprudence - though it be? It does leave a bad taste and uneasiness in everyone else's life.

In a similar way, the society feels about the left outs from its social insurance net. For them social assistance is given free. Food, accommodation will allow them just to keep body and soul together. They can of course avail of training and other facilities and make efforts to come out of their wretched social strata and move upwards; get out of sustenance on charity. 20% (or less) of the population gets social assistance because the rest of them, the 80% (or more) are under social insurance. It is because machinery is already setup and is in operation that the downtrodden too, get social relief as well as welfare measure. The presence of insurance cover for many and absence for some generates a frame of mind where there is a consensus in society permitting use of taxpayers' money for this social assistance. Similarly social insurance itself was born because normal insurance was well taken care of by the growing 'well-to-do' members of the society. But well being sought through insurance by 'criminally-inclined' definitely needs to be stamped out.

Insurance V/s Generosity

Criminal minded people are known to try to steal insurance claims, which are unwarranted. A person or a firm must not be better off after a loss has visited him or them. How would you like to settle claim of a murderer husband as heir to his wife's life insurance policy? Or where illness was hidden and a policy was wangled at disproportionately low premium, say, for a cancer patient? Moral hazards exist and need to be crushed, eliminated, for insurance business to remain worthy.

What about someone getting a new flat free after burning his establishment and making a fire insurance claim? Or someone getting his whole car painted out of a motor insurance claim from minor accident? Or was this accident self-inflicted?

Now generosity must not wink at such cheating under the alleged umbrella of social or economic well being. Insurance contracts are carefully drafted and need to be wisely interpreted. Shall I quote from holy Bible once again? It says "But we know that the law is good, if a man uses it lawfully."

The cost angle

In India, 3% of GDP or less goes on insurance. In USA, the world's largest user of insurance service has it at over 12% of their GDP. Is it worth it or is it a waste incurred to pamper a sense of well being or security to fulfill a psychological need?
We may take the reduction ad absurdom route to answer this issue. Can we do without insurance as they did before the 17th century? Some of our projects cost so much today that no one will venture producing goods by incurring that high an investment - if insurance cover is not there. The examples are aeroplanes, petrol refinery, oil tankers, steady satellites for TV and other communication, even large electricity generation plants etc. Is it not preferable to have insurance as well as giant projects than drop them both?

Social welfare is the end product we derive from the presence of insurance industry though it appears to need expenditure of high costs. Insurance costs a lot - about 20% of price is expenses.
Insurance they say has failed to give protection against inflation. I would say all wrong acts of governments including wars are out of bounds for grants of insurance cover. It is also a moral hazard.

Finally a loss means some resources have not performed. These resources cannot be conjured by insurance industry. You cannot replace the same husband. So prevention of loss is the first responsibility of the society and its citizens. That is why loss prevention association is sponsored by insurance industry.
How do we conclude? With all its constraints and limitations, insurance certainly is contributing in a small but irreplaceable way to social and economic life of the society. Insurance men and women must understand and appreciate all its plus and minus points and noticing the overwhelming presence of the plus side, work with all attachment, devotion and love. I assure every insurance man and woman that a well-contented retirement will be the end result you will be endowed with resorting to a devoted insurance career.

LESSON 25
INSURANCE SERVICES: POSITION IN INDIA AND PRIVATE INSURANCE COMPANIES IN INDIA

Lesson Objectives: **To make all aware of position of insurance services in India and working of private insurance companies in India.**

In recent past, various private sector companies have started their operations in India. With combined efforts and due to increased competition, it has become a HOT sector of the economy.

You are required to submit an electronic presentation and write up on position of insurance sector in India and Working of Private Insurance Companies in India (in both life and non-life sectors).

LESSON 26
MUTUAL FUNDS: AN INTRODUCTION

Lesson Objectives: **To understand the Concept of mutual funds,**
Its development in India and
Mutual fund schemes.

INTRODUCTION

A mutual fund is a financial intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is "mutual" as all of its returns, minus its expenses, are shared by the fund's investors.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 defines a mutual fund as a 'a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments'.

According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be set up in the form of a Trust under the Indian Trust Act. The definition has been further extended by allowing mutual funds to diversify their activities in the following areas:

- Portfolio management services
- Management of offshore funds
- Providing advice to offshore funds
- Management of pension or provident funds
- Management of venture capital funds
- Management of money market funds
- Management of real estate funds

A mutual fund serves as a link between the investor and the securities market by mobilising savings from the investors and investing them in the securities market to generate returns. Thus, a mutual fund is akin to portfolio management services (PMS). Although, both are conceptually same, they are different from each other. Portfolio management services are offered to high net worth individuals; taking into account their risk profile, their investments are managed separately. In the case of mutual funds, savings of small investors are pooled under a scheme and the returns are distributed in the same proportion in which the investments are made by the investors/unit-holders. Mutual fund is a collective savings scheme. Mutual funds play an important role in mobilising the savings of small investors and channelising the same for productive ventures in the Indian economy.

Benefits of Mutual Funds

An investor can invest directly in individual securities or indirectly through a financial intermediary. Globally, mutual funds have established themselves as the means of investment for the retail investor.

1. Professional management: An average investor lacks the knowledge of capital market operations and does not have large resources to reap the benefits of investment. Hence, he requires the help of an expert. It, is not only expensive to 'hire the services' of an expert but it is more difficult to identify a real expert. Mutual funds are managed by professional managers who have the requisite skills and experience to analyse the performance and prospects of companies. They make possible an organised investment strategy, which is hardly possible for an individual investor.
2. Portfolio diversification: An investor undertakes risk if he invests all his funds in a single scrip. Mutual funds invest in a number of companies across various industries and sectors. This diversification reduces the riskiness of the investments.
3. Reduction in transaction costs: Compared to direct investing in the capital market, investing through the funds is relatively less expensive as the benefit of economies of scale is passed on to the investors.
4. Liquidity: Often, investors cannot sell the securities held easily, while in case of mutual funds, they can easily encash their investment by selling their units to the fund if it is an open-ended scheme or selling them on a stock exchange if it is a close-ended scheme.
5. Convenience: Investing in mutual fund reduces paperwork, saves time and makes investment easy.
6. Flexibility: Mutual funds offer a family of schemes, and investors have the option of transferring their holdings from one scheme to the other.
7. Tax benefits Mutual fund investors now enjoy income-tax benefits. Dividends received from mutual funds' debt schemes are tax exempt to the overall limit of Rs 9,000 allowed under section 80L of the Income Tax Act.
8. Transparency Mutual funds transparently declare their portfolio every month. Thus an investor knows where his/her money is being deployed and in case they are not happy with the portfolio they can withdraw at a short notice.
9. Stability to the stock market Mutual funds have a large amount of funds which provide them economies of scale by which they can absorb any losses in the stock market and continue investing in the stock market. In addition, mutual funds increase liquidity in the money and capital market.
10. Equity research Mutual funds can afford information and data required for investments as they have large amount of funds and equity research teams available with them.

HISTORY OF MUTUAL FUNDS

The history of mutual funds, dates back to 19th century Europe, in particular, Great Britain. Robert Fleming set up in 1868 the first investment trust called Foreign and Colonial Investment Trust which promised to manage the finances of the moneyed classes of Scotland by spreading the investment over a number of different stocks. This investment trust and other investment trusts which were subsequently set up in Britain and the US, resembled today's close-ended mutual funds. The first mutual fund in the US, Massachusetts Investors' Trust, was setup in March 1924. This was the first open-ended mutual fund.

The stock market crash in 1929, the Great Depression, and the outbreak of the Second World War slackened the pace of growth of the mutual fund industry. Innovations in products and services increased the popularity of mutual funds in the 1950s and 1960s. The first international stock mutual fund was introduced in the US in 1940. In 1976, the first tax-exempt municipal bond funds emerged and in 1979, the first money market mutual funds were created. The latest additions are the international bond fund in 1986 and arm funds in 1990. This industry witnessed substantial growth in the eighties and nineties when there was a significant increase in the number of mutual funds, schemes, assets, and shareholders. In the US, the mutual fund industry registered a ten fold growth in the eighties (1980-89) only, with 25% of the household sector's investment in financial assets made through them. Fund assets increased from less than $150 billion in 1980 to over $4 trillion by the end of 1997. Since 1996, mutual fund assets have exceeded bank deposits. The mutual fund industry and the banking industry virtually rival each other in size.

Growth of Mutual Funds in India

The Indian mutual fund industry has evolved over distinct stages. The growth of the mutual fund industry in India can be divided into four phases: Phase I (1964-87), Phase II (1987-92), Phase III (1992-97), and Phase IV (beyond 1997).

Phase I: The mutual fund concept was introduced in India with the setting up of UTI in 1963. The Unit Trust of India (UTI) was the first mutual fund set up under the UTI Act, 1963, a special act of the Parliament. It became operational in 1964 with a major objective of mobilising savings through the sale of units and investing them in corporate securities for maximising yield and capital appreciation. This phase commenced with the launch of Unit Scheme 1964 (US-64) the first open-ended and the most popular scheme. UTI's investible funds, at market value (and including the book value of fixed assets) grew from Rs 49 crore in1965 to Rs 219 crore in 1970-71 to Rs 1,126 crore in 1980-81 and further to Rs 5,068 crore by June 1987. Its investor base had also grown to about 2 million investors. It launched innovative schemes during this phase. Its fund family included five income-oriented, open-ended schemes, which were sold largely through its agent network built up over the years. Master share, the equity growth fund launched in 1986, proved to be a grand marketing success. Master share was the first real close-ended scheme floated by UTI. It launched India Fund in 1986-the first Indian offshore fund for overseas investors, which was listed on the London Stock Exchange (LSE). UTI maintained its monopoly and experienced a consistent growth till 1987 .

Phase II: The second phase witnessed the entry of mutual fund companies sponsored by nationalised banks and insurance companies. In 1987, SBI Mutual Fund and Canbank Mutual Fund were set up as trusts under the Indian Trust Act, 1882. In 1988, UTI floated another offshore fund, namely, The India Growth Fund which was listed on the New York *Stock Exchange (NYSB). By 1990, the two nationalised insurance* giants, LIC and GIC, and nationalised banks, namely, Indian Bank, Bank of India, and Punjab National Bank had started operations of wholly-owned mutual fund subsidiaries. The assured return type of schemes floated by the mutual funds during this phase were perceived to be another banking product offered by the arms of sponsor banks. In October 1989, the first regulatory guidelines were issued by the

Reserve Bank of India, but they were applicable only to the mutual funds sponsored by FIIs. Subsequently, the Government of India issued comprehensive guidelines in June 1990 covering all 'mutual funds. These guidelines emphasised compulsory registration with SEBI and an arms length relationship be maintained between the sponsor and asset management company (AMC). With the entry of public sector funds, there was a tremendous growth in the size of the mutual fund industry with investible funds, at market value, increasing to Rs 53,462 crore and the number of investors increasing to over 23 million. The buoyant equity markets in 1991-92 and tax benefits under equity-linked savings schemes enhanced the attractiveness of equity funds.

Phase III: The year 1993 marked a turning point in the history of mutual funds in India. Tile Securities and Exchange Board of India (SEBI) issued the Mutual Fund Regulations in January 1993. SEBI notified regulations bringing all mutual funds except UTI under a common regulatory framework. Private domestic and foreign players were allowed entry in the mutual fund industry. Kothari group of companies, in joint venture with Pioneer, a US fund company, set up the first private mutual fund the Kothari Pioneer Mutual Fund, in 1993. Kothari Pioneer introduced the first open-ended fund Prima in 1993. Several other private sector mutual funds were set up during this phase. UTI launched a new scheme, Master-gain, in May 1992, which was a phenomenal success with a subscription of Rs 4,700 crore from 631akh applicants. The industry's investible funds at market value increased to Rs 78,655 crore and the number of investor accounts increased to 50 million. However, the year 1995 was the beginning of the sluggish phase of the mutual fund industry. During 1995 and 1996, unit holders saw an erosion in the value of their investments due to a decline in the NA V s of the equity funds. Moreover, the service quality of mutual funds declined due to a rapid growth in the number of investor accounts, and the inadequacy of service infrastructure. A lack of performance of the public sector funds and miserable failure of foreign funds like Morgan Stanley eroded the confidence of investors in fund managers. Investors perception about mutual funds, gradually turned negative. Mutual funds found it increasingly difficult to raise money. The average annual sales declined from about Rs 13,000 . crore in 1991-94 to about Rs 9,000 crore in 1995 and 1996.

Phase IV: During this phase, the flow of funds into the kitty of mutual funds sharply increased. This significant growth was aided by a more positive sentiment in the capital market, significant tax benefits, and improvement in the quality of investor service. Investible funds, at market value, of the industry rose by June 2000 to over Rs 1,10,000 crore with UTI having 68% of the market share. During 1999-2000 sales mobilisation reached a record level of Rs 73,000 crore as against Rs 31,420 crore in the preceding year. This trend was, however, sharply reversed in 2000-01. The UTI dropped a bombshell on the investing public by disclosing the NAV of US-64-its flagship scheme as on December 28,2000, just at Rs 5.81 as against the face value of Rs 10 and the last sale price of Rs 14.50. The disclosure of NAV of the country's largest mutual fund scheme was the biggest shock of the year to investors. Crumbling global equity markets, a sluggish economy coupled with bad investment decisions made life tough for big funds across the world in 2001-02. The effect of these problems was felt strongly in India also. Pioneer m, JP Morgan and Newton

Investment Management pulled out from the Indian market. Bank of India MF liquidated all its schemes in 2002.

The Indian mutual fund industry has stagnated at around Rs 1,00,000 crore assets since 2000-01. This stagnation is partly a result of stagnated equity markets and the indifferent performance by players. As against this, the aggregate deposits of Scheduled Commercial Banks (SCBs) as on May 3, 2002, stood at Rs 11,86,468 crore. Mutual funds assets under management (AUM) form just around 10% of deposits of SCBs.
The Unit Trust of India is losing out to other private sector players. While there has been an increase in AUM by around 11% during the year 2002, UTI on the contrary has lost more than 11% in AUM. The private sector mutual funds have benefited the most from the debacle ofUS-64 of UTI. The AUM of this sector grew by around- 60% for the year ending March 2002.

TYPES OF MUTUAL FUND SCHEMES

The objectives of mutual funds are to provide continuous liquidity and higher yields with high degree of safety to investors. Based on these objectives, different types of mutual fund schemes have evolved.
Types of Mutual Fund Schemes

Functional	*Portfolio*	Geographical	*Other*
Open-Ended Event	Income Funds	Domestic	Sectoral Specific
Close-Ended Scheme	Growth Funds	Off-shore	Tax Saving
Interval Scheme	Balanced Funds		ELSS
	Money Market		Special
	Mutual Funds		
			Gilt Funds
			Load Funds
			Index Funds
			ETFs
			PIE Ratio Fund

Functional Classification of Mutual Funds
1. Open-ended schemes: In case of open-ended schemes, the mutual fund continuously offers to sell and repurchase its units at net asset value (NAV) or NAV-related prices. Unlike close-ended schemes, open-ended ones do not have to be listed on the stock exchange and can also offer repurchase soon after allotment. Investors can enter and exit the scheme any time during the life of the fund. Open-ended schemes do not have a fixed corpus. The corpus of fund increases or decreases, depending on the purchase or redemption of units by investors.
There is no fixed redemption period in open-ended schemes, which can be terminated whenever the need arises. The fund offers a redemption price at which the holder can sell units to the fund and exit. Besides, an investor can enter the fund again by buying units from the fund at its offer price. Such funds announce sale and repurchase prices from time-to-time. UTI's US-64 scheme is an example of such a fund.

The key feature of open-ended funds is liquidity. They increase liquidity of the investors as the units can be continuously bought and sold. The investors can develop their income or saving plan due to free entry and exit frame of funds. Open-ended schemes usually come as a family of schemes which enable the investors to switch over from one scheme to another of same family.

2. Close-ended schemes: Close-ended schemes have a fixed corpus and a stipulated maturity period ranging between 2 to 5 years. Investors can invest in the scheme when it is launched. The scheme remains open for a period not exceeding 45 days. Investors in close-ended schemes can buy units only from the market, once initial subscriptions are over and thereafter the units are listed on the stock exchanges where they dm be bought and sold. The fund has no interaction with investors till redemption except for paying dividend/bonus. In order to provide an alternate exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. If an investor sells units directly to the fund, he cannot enter the fund again, as units bought back by the fund cannot be reissued. The close-ended scheme can be converted into an open-ended one. The units can be rolled over by the passing of a resolution by a majority of the unit-holders.

3. Interval scheme: Interval scheme combines the features of open-ended and close-ended schemes. They are open for sale or redemption during predetermined intervals at NAV-related prices.

Portfolio Classification

Here, classification is on the basis of nature and types of securities and objective of investment.

1. Income funds: The aim of income funds is to provide safety of investments and regular income to investors. Such schemes invest predominantly in income-bearing instruments like bonds, debentures, government securities, and commercial paper. The return as well as the risk are lower in income funds as compared to growth funds.
2. Growth funds: The main objective of growth funds is capital appreciation over the medium-to-long term. They invest most of the corpus in equity shares with significant growth potential and they offer higher return to investors in the long-term. They assume the risks associated with equity investments. There is no guarantee or assurance of returns. These schemes are usually close-ended and listed on stock exchanges.
3. Balanced funds: The aim of balanced scheme is to provide both capital appreciation and regular income. They divide their investment between equity shares and fixed nice-bearing instruments in such a proportion that, the portfolio is balanced. The portfolio of such funds usually comprises of companies with good profit and dividend track records. Their exposure to risk is moderate and they offer a reasonable rate of return.
4. Money market mutual funds: They specialise in investing in short-term money market instruments like treasury bills, and certificate of deposits. The objective of such funds is high liquidity with low rate of return.

Geographical Classification

1. Domestic funds: Funds which mobilise resources from a particular geographical locality like a country or region are domestic funds. The market is limited and confined to the boundaries of a nation in which the fund operates. They can invest only in the securities which are issued and traded in the domestic financial markets.
2. Offshore funds: Offshore funds attract foreign capital for investment in 'the country of the issuing company. They facilitate cross-border fund flow which leads to an increase in foreign currency and foreign exchange reserves. Such mutual funds can invest in securities of foreign companies. They open domestic capital market to international investors. Many mutual funds in India have launched a number of offshore funds, either independently or jointly with foreign investment management companies. The first offshore fund, the India Fund, was launched by Unit Trust of India in July 1986 in collaboration with the US fund manager, Merril Lynch.

Others

1. Sectoral: These funds invest in specific core sectors like energy, telecommunications, IT, construction, transportation, and financial services. Some of these newly opened-up sectors offer good investment potential.

2. Tax saving schemes: Tax-saving schemes are designed on the basis of tax policy with special tax incentives to investors. Mutual funds have introduced a number of tax-saving schemes. These are close-ended schemes and investments are made for ten years, although investors can avail of encashment facilities after 3 years. These schemes contain various options like income, growth or capital application. The latest scheme offered is the Systematic Withdrawal Plan (SWP) which enables investors to reduce their tax incidence on dividends from as high as 30% to as low as 3 to 4%.

3. Equity-linked savings scheme (ELSS): In order to encourage investors to invest in equity market, the government has given tax-concessions through special schemes. Investment in these schemes entitles the investor to claim an income tax rebate, but these schemes carry a lock-in period before the end of which funds cannot be withdrawn.

4. Special schemes: Mutual funds have launched special schemes to cater to the special needs of investors. UTI has launched special schemes such as Children's Gift Growth Fund, 1986, Housing Unit Scheme, 1992, and Venture Capital Funds.

5. Gilt funds: Mutual funds which deal exclusively in gilts are called gilt funds. With a view to creating a wider investor base for government securities, the Reserve Bank of India encouraged setting up of gilt funds. These funds are provided liquidity support by the Reserve Bank.

6. Load funds: Mutual funds incur certain expenses such as brokerage, marketing expenses, and communication expenses. These expenses are known as 'load' and are recovered by the fund when it sells the units to investors or repurchases the units from

withholders. In other words, load is a sales charge, or commission, assessed by certain mutual funds to cover their selling costs.

Loads can be of two types-Front-end-load and back-end-load. Front-end-load, or sale load, is a charge collected at the time when an investor enters into the scheme. Back-end, or repurchase, load is a charge collected when the investor gets out of the scheme. Schemes that do not charge a load are called 'No load' schemes. In other words, if the asset management company (AMC) bears the load during the initial launch of the scheme, then these schemes are known as no-load schemes. However, these no-load schemes can have an exit load when the unit holder gets out of the scheme before a I stipulated period mentioned in the initial offer. This is done to prevent short-term investments and redemptions. Some funds may also charge different amount of loads to investors depending upon the time period the investor has stayed with the funds. The longer the investor stays with the fund, less is the amount of exit load charged. This is known as contingent deferred sales' charge (CDSL). It is a back-end (exit load) fee imposed by certain funds on shares redeemed with a specific period following their purchase and is usually assessed on a sliding scale.

7. Index funds: An index fund is a mutual fund which invests in securities in the index on which it is based BSE Sensex or S&P CNX Nifty. It invests only in those shares which comprise the market index and in exactly the same proportion as the companies/weightage in the index so that the value of such index funds varies with the market index. An index fund follows a passive investment strategy as no effort is made by the fund manager to identify stocks for investment/dis-investment. The fund manager has to merely track the index on which it is based. His portfolio will need an adjustment in case there is a revision in the underlying index. In other words, the fund manager has to buy stocks which are added to the index and sell stocks which are deleted from the index.

Internationally, index funds are very popular. Around one-third of professionally run portfolios in the US are index funds. Empirical evidence points out that active fund managers have not been able to perform well. Only 20-25% of actively managed equity mutual funds out-perform benchmark indices in the long-term. These active fund managers park 80% of their money in an index and do active management on the remaining 20%. Moreover, risk averse investors like provident funds and pension funds prefer investment in passively managed funds like index funds.

8. PIE ratio fund: PIE ratio fund is another mutual fund variant that is offered by Pioneer IT! Mutual Fund. The PIE (Price-Earnings) ratio is the ratio of the price of the stock of a company to its earnings per share (EPS). The PIE ratio of the index is the weighted average price-earnings ratio of all its constituent stocks.
The PIE ratio fund invests in equities and debt instruments wherein the proportion of the investment is determined by the ongoing price-earnings multiple of the market. Broadly, around 90% of the investible funds will be invested in equity if the Nifty Index PIE ratio is 12 or below. If this ratio exceeds 28, the investment will be in debt/money markets. Between the two ends of 12 and 28 PIE ratio of the Nifty, the fund will allocate varying proportions of its investible funds to equity and debt. The

objective of this scheme is to provide superior risk-adjusted returns through a balanced portfolio of equity and debt instruments.

9. Exchange traded funds: Exchange Traded Funds (ETFs) are a hybrid of open-ended mutual funds and listed individual stocks. They are listed on stock exchanges and trade like individual stocks on the stock exchange. However, trading at the stock exchanges does not affect their portfolio. ETFs do not sell their shares directly to investors for cash. The shares are offered to investors over the stock exchange. ETFs are basically passively managed funds that track a particular index such as S&P CNX Nifty.
Since they are listed on stock exchanges, it is possible to buy and sell them throughout the day and their price is determined by the demand-supply forces in the market. In practice, they trade in a small range around the value of the assets (NAV) held by them.

ETFs offer several distinct advantages. .

- ETFs bring the trading and real time pricing advantages of individual stocks to mutual funds. The ability to trade intra-day at prices that are usually close to the actual intra-day NAV of the scheme makes it almost real-time trading.
- ETFs are simpler to understand and hence they can attract small investors who are deterred to trade in index futures due to requirement of minimum contract size. Small investors can buy minimum one unit of ETF, can place limit orders and trade intra-day. This, in turn, would increase liquidity of the cash market.
- ETFs can be used to arbitrate effectively between index futures and spot index.
- ETFs provide the benefits of diversified index funds. The investor can benefit from the flexibility of stocks as well as the diversification.
- ETFs being passively managed, have somewhat higher NAV against an index fund of the same portfolio. The operating expenses of ETFs are lower than even those of similar index funds as they do not have to service investors who deal in shares through stock exchanges.
- ETFs can be beneficial for financial institutions also. Financial institutions can use ETFs for utilizing idle cash, managing redemptions, modifying sector allocations, and hedging market exposure.

The first exchange traded fund-Standard and Poor's Depository Receipt (SPDR-also called Spider)was launched in the US in 1993. ETFs have grown rapidly with around US$100 billion in assets as on December 2001. Today, about 60% of trading value on the American Stock Exchange (AMEX) is from ETFs. ETFs were launched in Europe and Asia in 2001. Currently, more than 120 ETFs are available in US, Europe, Singapore, Hongkong, Japan, and other countries. Among the popular ones are SPDRs (Spiders) based on the S&P 500 Index, QQQs (cubes) based on the Nasdaq-100 Index, i SHARES based on MSCI Indices and TRAHK (Tracks) based on the Hang Seng Index. The ETF structure has seen over $120 bn pouring into it in more than 220 funds. It has become the fastest growing fund structure. In year 2001 alone, the number of funds doubled from 100 to 200.

The first ETF to be introduced in India is Nifty Bench mark Exchange-Traded Scheme *(Nifty* BeES). It is an open-ended ETF, launched towards the end of 2001 by Benchmark Mutual Funds. The fund is listed in the capital market segment of the

NSE and trades the S&P CNX Nifty Index. The Benchmark Asset Management Company has become the first company in Asia (excluding Japan) to introduce ETF.
Net Asset Value The net asset value of a fund is the market value of the assets minus the liabilities on the day of valuation. In other words, it is the amount which the shareholders will collectively get if the fund is dissolved or liquidated. The net asset value of a unit is the net asset value of fund divided by the number of outstanding units.
Thus NAV = Market Price of Securities + Other Assets - Total Liabilities + Units Outstanding as at the NAV date.
NAV = Net Assets of the Scheme + Number of units outstanding, that is, Market value of investments + Receivables + Other Accrued Income + Other Assets - Accrued Expenses - Other Payables - Other Liabilities + No. of units outstanding as at the NAV date.

A fund's NAV is affected by four sets of factors: purchase and sale of investment securities, valuation of all investment securities held, other assets and liabilities, and units sold or redeemed.
SEBI has issued guidelines on valuation of traded securities, thinly traded securities and non-traded securities. These guidelines were issued to streamline the procedure of calculation of NAV of the schemes of mutual funds. The aggregate value of illiquid securities as defined in the guidelines shall not exceed 15% of the total assets of the scheme and any illiquid securities held above 15% of the total assets shall be valued in the manner as specified in the guidelines issued by the SEBI. Where income receivables on investments has accrued but has not been received for the period specified in the guidelines issued by SEBI, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by SEBI.

Mutual funds are required to declare their NA V s and sale-repurchase prices of all schemes updated daily on regular basis on the AMFI website by 8.00 p.m. and declare NA V s of their close-ended schemes on every Wednesday.
According to SEBI (Mutual Funds) (Second Amendment) Regulations, 2000, a mutual fund can now invest up to 5% of its NAV in the unlisted equity shares or equity related instruments in case of open-ended schemes; while in case of close-ended schemes, the mutual fund can now invest up to 10% of its NAY.

Mutual Fund Investors

Mutual funds in India are open to investment by

(a) Residents including

- Resident Indian Individuals, including high net worth individuals and the retail or small investors. Indian Companies
- Indian Trusts/Charitable Institutions
- Banks
- Non-Banking Finance Companies
- Insurance Companies
- Provident Funds

(b) Non-Residents, including

- Non-Resident Indians

- Other Corporate Bodies (OCBs)

(c) Foreign entities, namely, Foreign Institutional Investors (FIIs) registered with SEBI. Foreign citizens/ entities are however not allowed to invest in mutual funds in India.

LESSON 27
MUTUAL FUNDS: SEBI AND REGULATORY FRAMEWORK

Lesson Objectives: **To learn about the organization and working of mutual funds with respect to UTI,**
SEBI and other regulatory framework for mutual fund.

ORGANIZATION OF A MUTUAL FUND:

Three key players namely sponsor, mutual fund trust, and asset management company (AMC) are involved in setting up a mutual fund. They are assisted by other independent administrative entities like banks, registrars, transfer agents, and custodians (depository participants).

Sponsor

Sponsor means any person who acting alone or with another body corporate establishes a mutual fund. The sponsor of a fund is akin to the promoter of a company as he gets the fund registered with SEBI. SEBI will register the mutual fund if the sponsor fulfills the following criteria:

- The sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions. This means that the sponsor should have been doing business in financial services for not less than five years, with positive net worth in all the immediately preceding five years. The net worth of the immediately preceding year should be more than the capital contribution of the sponsor in AMC and the sponsor should show profits after providing depreciation, interest, and tax for three out of the immediately preceding five years.
- The sponsor and any of the directors or principal officers to be employed by the mutual fund, should not have been found guilty of fraud or convicted of an offence involving moral turpitude or guilty of economic offences.

The sponsor forms a trust and appoints a Board of Trustees. He also appoints an Asset Management Company as fund managers. The sponsor, either directly or acting through the Trustees, also appoints a custodian to hold the fund assets. The sponsor is required to contribute at least 40% of the minimum net worth of the asset management company.

Mutual Funds as Trusts

A mutual fund in India is constituted in the form of a public Trust created under the Indian Trusts Act, 1882. The sponsor forms the Trust and registers it with SEBI. The fund sponsor acts as the settler of the Trust, contributing to its initial capital and appoints a trustee to hold the assets of the Trust for the benefit of the unit holders, who are the beneficiaries of the Trust. The fund then invites investors to contribute their money in the common pool, by subscribing to 'units' issued by various schemes established by the Trust as evidence of their beneficial interest in the fund. Thus, a mutual fund is just a 'pass through' vehicle. Most of the funds in India are managed by the Board of Trustees, which is an independent body and acts as protector of the unit holders' interests. At least, 50% of the trustees shall be

independent trustees (who are not associated with an associate, subsidiary, or sponsor in any manner). The trustees shall be accountable for and be the custodian of funds/property of respective scheme.

Asset Management Company

The trustees appoint the Asset Management Company (AMC) with the prior approval of SEBI. The AMC is a company formed and registered under the Companies Act, 1956, to manage the affairs of the mutual fund and operate the schemes of such mutual funds. It charges a fee for the services it renders to the mutual fund trust. It acts as the investment manager to the Trust under the supervision and direction of the trustees. The AMC, in the name of the Trust, floats and then manages the different investment schemes as per SEBI regulations and the Trust Deed. The AMC should be registered with SEBI. The AMC of a mutual fund must have a net worth of at least Rs 10 crore at all times and this net worth should be in the form of cash. It cannot act as a trustee of any other mutual fund. It is required to disclose the scheme particulars and base of calculation of NAY. It can undertake specific activities such as advisory services and financial consultancy. It must submit quarterly reports to the mutual fund. The trustees are empowered to terminate the appointment of the AMC and may appoint a new AMC with the prior approval of the SEBI and unit-holders. At least 50% of the directors of the board of directors of AMC should not be associated with the sponsor or its subsidiaries or the trustees.

Obligations of an AMC An AMC has to follow a number of obligations. They are:

- The AMC shall take all the reasonable steps and exercise due diligence to ensure that any scheme is not contrary to the Trust deed and provisions of investment of funds pertaining to any scheme is not contrary to the provisions of the regulations and Trust deed.
- The AMC shall exercise due diligence and care in all its investment decisions. The AMC shall be responsible for the acts of commission or commissions by its employees or the persons whose services have been procured.
- An AMC shall submit to the trustee's quarterly reports.
- The trustees at the request of an AMC can terminate the assignments of the AMC.
- An AMC shall not deal in securities through any broker associated with a sponsor or a firm which is an associate of sponsor beyond 5% of the daily gross business of the mutual fund.
- No AMC shall utilize services of the sponsor or any of its associates, employees, or their relatives for the purpose of any securities transaction and distribution and sale of securities, unless disclosure is made to the unit-holders and brokerage/commission paid is disclosed in half-yearly accounts of the mutual fund.
- No person, who has been found guilty of any economic offence or involved in violation of securities law, should be appointed as key personnel. . The AMC shall abide by the code of conduct specified in the fifth schedule. The registrars and share transfer agents to be appointed by AMC are to be registered with SEBI.

SEBI regulations (2001) provide for exercise of due diligence by asset management companies (AMCs) in their investment decisions. For effective implementation of the regulations and also to bring about transparency in the investment decisions, all the AMCs are required to maintain records in support of each investment decision, which would indicate the data, facts, and other opinions leading to an investment decision. While the AMCs can prescribe broad parameters for investments, the basis for taking individual scrip-wise investment decision in equity and debt securities would have to be recorded. The AMCs are required to report its compliance in their periodical reports to the trustees and the trustees are required to report to SEBI, in their half-yearly reports. Trustees can also check its compliance through independent auditors or internal statutory auditors or through other systems developed by them.

The unclaimed redemption and dividend amounts can now be deployed by the mutual funds in call money market or money market instruments and the investors who claim these amounts during a period of three years from the due date shall be paid at the prevailing net asset value. After a period of three years, the amount can be transferred to a pool account and the investors can claim the amount at NAV prevailing at the end of the third year. The income earned on such funds can be used for the purpose of investor education. The AMC has to make a continuous effort to remind the investors through letters to take their unclaimed amounts. In case of schemes to be launched in the future, disclosures on the above provisions are required to be made on the offer documents. Also, the information on amount unclaimed and number of such investors for each scheme is required to be disclosed in the annual reports of mutual funds.

SEBI issued a directive during 2000-01 that the annual report containing accounts of the asset management companies should be displayed on the websites of the mutual funds. It should also be mentioned in the annual report of mutual fund schemes that the unit-holders, if they so desire, can request for the annual report of the asset management company.

Mutual funds earlier were required to get prior approval of the board of trustees and AMCs to invest in un-rated debt instruments. In order to give operational flexibility, mutual funds can now constitute committees who can approve proposals for investments in un-rated debt instruments. However, the detailed parameters for such investments must be approved by the AMC boards and trustees. The details of such investments are required to be communicated by the AMCs to the trustees in their periodical reports and it should be clearly mentioned as to how the parameters have been complied with. However, in case a security does not fall under the parameters, the prior approval of the board of the AMC and trustees is required to be taken. .

SEBI issued guidelines for investment/trading in securities by employees of AMCs and mutual fund trustee companies, so as to avoid any conflict of interest or any abuse of an individual's position and also to ensure that the employees of AMCs and trustee companies should not take undue advantage of price sensitive information about any company.

SEBI issued directives that the directors' of AMCs should file with the trustees the details of their purchase and sale transactions in securities on a quarterly basis. As in

the case of trustees, they may report only those transactions which exceed the value of Rs 1 lakh. Following representations from AMFI, SEBI notified the Mutual Funds (Amendment) Regulations, 2002, whereby the requirement of publishing of scheme-wise annual report in the newspapers by the mutual funds was waived. However, mutual funds shall continue to send the annual report or abridged annual report to the unit -holders. Further, all mutual funds were advised to display the scheme-wise annual reports on their websites to be linked with AMFI website so that the investors and analysts can access the annual reports of all mutual funds at one place.

To provide the investors an objective analysis of the performance of the mutual funds schemes in comparison with the rise or fall in the markets, SEBI decided to include disclosure of performance of benchmark indices in case of equity-oriented schemes and subsequently extended to debt-oriented and balanced fund schemes in the format for half-yearly results. In case of sector or industry specific schemes, mutual funds may select any sectoral indices published by stock exchanges and other reputed agencies.

In pursuance with the proposals in the Union Budget 2002-03, SEBI allowed the mutual funds to invest in foreign debt securities in the countries with full convertible currencies and with highest rating (foreign currency credit rating) by accredited/registered credit rating agencies. They were also allowed to invest in government securities where the countries are AAA rated.

To bring, uniformity in calculation of NAVs of mutual fund schemes, SEBI issued guidelines for valuation of unlisted equity shares.
SEBI clarified that the service charge of five% on the management fees of AMCs imposed in the Union Budget 2002-03 can be charged to the schemes as an item of general expenditure without imposing an additional burden on unit-holders.
SEBI advised mutual funds that the non-performing or illiquid assets at the time of maturity/closure of schemes but realised within two years after the winding up of the scheme, should be distributed to the old investors if the amount is substantial. In case the amount is not substantial or it is realised after two years it may be transferred to the Investor Education Fund maintained by each mutual fund.

Mutual funds can enter into transactions relating to government securities only in dematerialised form. SEBI clarified that the SEBI (Insider Trading) (Amendment) Regulations, 2002, should be followed strictly by the trustee companies, AMCs and their employees and directors.
SEBI (Mutual Funds) Regulations, 1996 The provision of this regulation pertaining to AMC are:

- All the schemes to be launched by the AMC need to be approved by the trustees and copies of offer documents of such schemes are to be filed with SEBI.
- The offer documents shall contain adequate disclosures to enable the investors to make informed decisions.
- Advertisements in respect of schemes should be in conformity with the SEBI prescribed advertisement code, and disclose the method and periodicity of

valuation of investment sales and repurchase in addition to the investment objectives.

- The listing of close-ended schemes is mandatory and every close-ended scheme should be listed on a recognised stock exchange within six months from the closure of subscription. However, listing is not mandatory in case the scheme provides for monthly income or caters to the special classes of persons like senior citizens, women, children, and physically handicapped; if the scheme discloses details of repurchase in the offer document; if the scheme opens for repurchase within six months of closure of subscription.
- Units of a close-ended scheme can be opened for sale or redemption at a predetermined fixed interval if the minimum and maximum amount of sale, redemption, and periodicity is disclosed in the offer document.
- Units of a close-ended scheme can also be converted into an open-ended scheme with the consent of a majority of the unit-holders and disclosure is made in the offer document about the option and period of conversion.
- Units of a close-ended scheme may be rolled over by passing a resolution by a majority of the shareholders.
- No scheme other than unit-linked scheme can be opened for subscription for more than 45 days. . The AMC must specify in the offer document about the minimum subscription and the extent of over subscription, which is intended to be retained. In the case of over-subscription, all applicants applying up to 5,000 units must be given full allotment subject to over subscription.
- The AMC must refund the application money if minimum subscription is not received, and also the excess over subscription within six weeks of closure of subscription.
- Guaranteed returns can be provided in a scheme if such returns are fully guaranteed by the AMC or sponsor. In such cases, there should be a statement indicating the name of the person, and the manner in which the guarantee is to be made must be stated in the offer document.
- . A close-ended scheme shall be wound up on redemption date, unless it is rolled over, or if 75% of the unit-holders of a scheme pass a resolution for winding up of the scheme; if the trustees on the happening of any event require the scheme to be wound up; or if SEBI, so directs in the interest of investors.

Investment Objectives and Valuation Policies The price at which the units may be subscribed or sold and the price at which such units may at any time be repurchased by the mutual fund shall be made available to the investors.

General Obligations These obligations are: .

- Every asset management company for each scheme shall keep and maintain proper books of accounts, records, and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund and intimate to the Board the place where such books of accounts, record, and documents are maintained.
- The financial year for all the schemes shall end as of March 31 of each year. Every mutual fund or the asset management company shall prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

- Every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the asset management company.

Procedure in Case of Default On and from the date of the suspension of the certificate or the approval, as the case may be, the mutual fund, trustees or asset management company, .shall cease to carry on any activity as a mutual fund, trustee or asset management company, during the period of suspension, and shall be subject to the directions of the Board with regard to any records, documents, or securities that may be in its custody or control, relating to its activities as mutual fund, trustees, or asset management company.

SEBI Guidelines (2001-02) Relating to Mutual Funds

- A common format is prescribed for all mutual fund schemes to disclose their entire portfolios on half yearly basis so that the investors can get meaningful information on the deployment of funds. Mutual funds are also required to disclose the investment in various types of instruments and percentage of investment in each scrip to the total NAV, illiquid and non-performing assets, investment in derivatives and in ADRs and GDRs.
- To enable the investors to make informed investment decisions, mutual funds have been directed to fully revise and update offer document and memorandum at least once in two years.
- Mutual funds are also required to
  (i) bring uniformity in disclosures of various categories of advertisements, with a view to ensuring consistency and comparability across schemes of various and mutual funds.
  (ii) reduce initial offer period from a maximum of 45 days to 30 days. .
  (iii) dispatch statements of account once the minimum subscription amount specified in the offer document is received even before the closure of the issue.
  (iv) invest in mortgaged backed securities of investment grade given by credit rating agency.
  (v) identify and make provisions for the non-performing assets (NPAs) according to criteria for classification of NPAs and treatment of income accrued on NPAs and to disclose NPAs in half yearly portfolio reports.
  (vi) disclose information in a revised format on unit capital, reserves, performance in terms of dividend and rise/fall in NAV during the half-year period, annualised yields over the last 1, 3, 5 years in addition to percentage of management fees, percentage of recurring expenses to net assets, investment made in associate companies, payment made to associate companies for their services, and details of large holdings, since their operation.
  (vii) declare their NA V s and sale/repurchase prices of all schemes updated daily on regular basis on the AMFI website by 8.00 p.m. and declare NA V s of their close-ended schemes on every Wednesday.
- The format for un-audited half-yearly results for the mutual funds has been revised by SEBI. These results are to be published before the expiry of one month from the close of each half-year as against two months period provided earlier. These results shall also be put in their websites by mutual funds.

- All the schemes by mutual funds shall be launched within six months from the date of the letter containing observations from SEBI on the scheme offer document. Otherwise, a fresh offer document along with filing fees shall be filed with SEBI.
- Mutual funds are required to disclose large unit-holdings in the scheme, which are over 25% of the NAY.

ASSOCIATION OF MUTUAL FUNDS IN INDIA

The Association of Mutual Funds in India (AMFI) was established in 1993 when all the mutual funds, except the UTI, came together realising the need for a common forum for addressing the issues that affect the mutual fund industry as a whole. The AMFI is dedicated to developing the Indian mutual fund industry on professional, health, and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit-holders.

Objectives of AMFI
To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.

- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management, including agencies connected or involved in the field of capital markets and financial services.
- To interact with the SEBI and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the government, Reserve Bank of India and other bodies on all matters relating to the mutual fund industry.
- To develop a cadre of well trained agent distributors and to implement a programme of training and certification for all intermediaries and others engaged in the industry.
- To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on mutual fund industry and to undertake studies and research directly and! or in association with other bodies.

AMFI continues to play its role as a catalyst for setting new standards and refining existing ones in many areas, particularly in the sphere of valuation of securities. Based on the recommendations of AMFI, detailed guidelines have been issued by SEBI for valuation of unlisted equity shares.
A major initiative of AMFI during the year 2001-02 was the launching of registration of AMFI Certified Intermediaries and providing recognition and status to the distributor agents. More than 30 corporate distributors and a large number of agent distributors have registered with AMFI. The AMFI Guidelines and Norms for Intermediaries (AGNI) released in February 2002, gives a framework of rules and guidelines for the intermediaries and for the conduct of their business.

AMFI maintains a liaison with different regulators such as SEBI, IRDA, and RBI to prevent any over regulation that may stifle the growth of the industry. AMFI has set

up a working group to formulate draft guidelines for pension scheme by mutual funds for submission to IRDA. It holds meetings and discussions with SEBI regarding matters relating to mutual fund industry. Moreover, it also makes representations to the government for removal of constraints and bottlenecks in the growth of mutual fund industry.

AMFI recently launched appropriate market indices which will enable the investors to appreciate and make meaningful comparison of the returns of their investments in mutual funds schemes. While in the case of equity funds, a number of benchmarks like the BSE Sensex and the S&P CNX Nifty are available, there was a lack of relevant benchmarks for debt funds. AMFI took the initiative of developing eight new indices jointly with Crisil.com and ICICI Securities. These indices have been constructed to benchmark the performance of different types of debt schemes such as liquid, income, monthly income, balanced fund, and gilt fund schemes. These eight new market indices are Liquid Fund Index (Liqui fex), Composite Bond Fund Index (Compbex), Balanced Fund Index (Balance EX), MIP Index (MIPEX), Short Maturity Gilt Index (Si-Bex), Medium Maturity Gilt Index (Mi-Bex), Long Maturity Gilt Index (Li-Bex) and the Composite Gilt Index.

In the case of liquid funds, the index comprises a commercial paper (CP) component with a 60% weightage and an inter-bank call money market component with a 40% weightage. The CP component of the index is computed using the weighted average issuance yield on new 91 days CPs issued by top rated manufacturing companies. In the case of bond funds, the index comprises a corporate bond component with a 55% weightage, gilts component with a 30% weightage call component with 10% weightage and commercial paper with 5% weightage. The index's 55% bond component is split based on a 40 point share of AA rated bonds, and 15 points share of AA rated bonds.

Mutual funds have now to disclose also the performance of appropriate market indices along with the performance of schemes both in the offer document and in the half-yearly results. Further, the trustees are required to review the performance of the schemes on periodical basis with reference to market indices. These indices will be useful to distribution companies, agents/brokers, financial consultants, and investors.

AMFI conducts investor awareness programmes regularly. AMFI also conducts intermediary’s certification examination. As of July 2002, 2,140 employees and 3,200 distributors have passed the certification examination conducted by AMFI.
AMFI is in the process of becoming a self- regulatory organisation (SRO). It has set up a committee to set the norms for AMFI to become an SRO.

UNIT TRUST OF INDIA

Unit Trust of India (UTI) is India's first mutual fund organisation. It is the single largest mutual fund in India, which came into existence with the enactment of UTI Act in 1964.
The economic turmoil and the wars in the early sixties depressed the financial markets, making it difficult for both existing and new entrepreneurs to raise fresh

capital. The then Finance Minister, T T Krishnamachari, set up the idea of a Unit Trust which would mobilise savings of the community and invest these savings in the capital market. His ideas took the form of the Unit Trust of India, which commenced operations from July 1964 'with a view to encouraging savings and investment and participation in the income, profits and gains accruing to the Corporation from the acquisition, holding, management and disposal of securities'. The regulations passed by the Ministry of Finance (MOF) and the Parliament from time to time regulated the functioning of UTI. Different provisions of the UTI Act laid down the structure of management, scope of business, powers and functions of the Trust as well as accounting, disclosures, and regulatory requirements for the Trust.

UTI was set up as a trust without ownership capital and with an independent Board of Trustees. The Board of Trustees manages the affairs and business of UTI. The Board performs its functions, keeping in view the interest of the unit-holders under various schemes.
UTI has a wide distribution network of 54 branch offices, 266 chief representatives and about 67,000 agents. These Chief representatives supervise agents. UTI manages 72 schemes and has an investor base of 20.02 million investors. UTI has set up 183 collection centres to serve investors. It has 57 franchisee offices which accept applications and distribute certificates to unit-holders.
UTI's mission statement is to meet the investor's diverse income and liquidity needs by creation of appropriate schemes; to offer best possible returns on his investment, and render him prompt and efficient service, beyond normal customer expectations.

UTI was the first mutual fund to launch India Fund, an offshore mutual fund in 1986. The India Fund was launched as a close-ended fund but became a multi-class, open-ended fund in 1994. Thereafter, UTI floated the India Growth Fund in 1988, the Columbus India Fund in 1994, and the India Access Fund in 1996. The India Growth Fund is listed on the New York Stock Exchange. The India Access Fund is an Indian Index Fund, tracking the NSE 50 index.
UTI's Associates
UTI has set up associate companies in the fields of banking, securities trading, investor servicing, investment advice and training, towards creating a diversified financial conglomerate and meeting investors' varying needs under a common umbrella.

UTI Bank Limited UTI Bank was the first private sector bank to be set up in 1994. The Bank has a network of 121 fully computerised branches spread across the country. The Bank offers a wide range of retail, corporate and forex services.
UTI Securities Exchange Limited UTI Securities Exchange Limited was the first institutionally sponsored corporate stock broking firm incorporated on June 28, 1994, with a paid-up capital of Rs 300 millions wholly owned by UTI and promoted to provide secondary market trading facilities, investment banking, and other related services. It has acquired membership of NSE, BSE, OTCEI, and Ahmedabad Stock Exchange (ASE).
UTI Investor Services Limited UTI Investor Services Limited was the first institutionally sponsored Registrar and Transfer agency set up in 1993. It helps UTI in rendering prompt and efficient services to the investors.

UTI Institute of Capital Markets UTI Institute of Capital Market was set up in 1989 as a non-profit educational society to promote professional development of capital market participants. It provides specialised professional development programmes for the varied constituents of the capital market and is engaged in research and consultancy services. It also serves as a forum to discuss ideas and issues relevant to the capital market.

UTI Investment Advisory Services Limited UTI Investment Advisory Services Limited, the first Indian investment advisor registered with SEC, US, was set up in 1988 to provide investment research and back office support to other offshore funds of UTI.

UTI International Limited UTI International Limited is a 100% subsidiary of UTI, registered in the island of Guernsey, Channel Islands. It was set up with the objective of helping in the UTI offshore funds in marketing their products and managing funds. UTI International Limited has an office in London, which is responsible for developing new products, new business opportunities, maintaining relations with foreign investors, and improving communication between UTI and its clients and distributors abroad.

UTI has a branch office at Dubai, which caters to the needs of NRI investors based in six Gulf countries, namely, UAE, Oman, Kuwait, Saudi Arabia, Qatar, and Bahrain. This branch office acts as a liaison office between NRI investors in the Gulf and UTI offices in India.

UTI has extended its support to the development of unit trusts in Sri Lanka and Egypt. It has participated in the equity capital of the Unit Trust Management Company of Sri Lanka.

Promotion of Institutions

The Unit Trust of India has helped in promoting/co-promoting many institutions for the healthy development of financial sector. These institutions are:

- Infrastructure Leasing and Financial Services (ILFS).
- Credit Rating and Information Services Limited (CRISIL).
- Stock Holding Corporation of India Limited (SHCIL).
- Technology Development Corporation of India Limited (TDCIL).
- Over the Counter Exchange of India Limited (OCEI).
- National Securities Depository Limited (NSDL).
- North-Eastern Development Finance Corporation Limited (NEDFCL).

Product Range

UTI offers a wide variety of schemes to investors. Apart from equity, debt, and balanced schemes, UTI offers schemes which meet specific needs like low cost insurance cover (Unit Linked Insurance Plan), monthly income needs of retired persons and women, income and liquidity needs of religious and charitable institutions and trusts, building up of funds to meet cost of higher education and career plans for children, future wealth and income needs of the girl child and women, building savings to cover medical insurance at old age, and wealth accumulation to meet income needs after retirement.

Schemewise Assistance Sanctioned and Disbursed to the Corporate Sector by UTI

(Rs in crore)

Form of Assistance		*Sanctions*						*Disbursements*				
	1996-97	1997-98	1998-99	*1999-2000*	*2000-01*	*Cumulative upto end March 2001*	1996-97	1997-98	1998-99	*1999-2000*	*2000-01*	*Cumulative upto end March 2001*
Direct Finance												
A. Project Finance												
i) Loans	-	-	-	-	-	11,253.60	17.44	8.71	6.13	-	-	8,341.85
ii) Underwriting and direct subscriptions	3,346.15	4,471.48	3,898.58	6,737.15	3,505.14	45,864.40	3,061.82	3,402.75	3,429.78	5,069.87	3,021.36	34,406.88
iii) Deferred payment Guarantees	-	-	-	-	2,459.15	2,459.15	-	-	-	-	1,570.51	1,570.51
Sub-Total (A)	3,346.15	4,471.44	3,898.58	6,737.15	5,964.29	59,577.15	3,079.26	3,411.46	3,435.91	5,069.87	4,591.87	44,319.24
B. Non-Project Finance												
i) Working Capital! Short-Term Loans	286.90	117.00	91.50	100.25	8.00	-	140.00	87.50	62.00	92.00	8.00	-
ii) Equipment Leasing	-	-	-	-	-	-	-	-	-	-	-	-
iii) Investments	-	-	.50	7.50	-	8,785.15	18.00	-	.30	.20	-	7,950.55
Sub-Total (B)	286.90	117.00	92.00	107.75	8.00	8,785.15	158.00	87.50	62.30	92.20	8.00	7,950.55
Total	3,633.05	4,588.44	3,990.58	6,844.90	5,972.29	68,362.30	3,237.26	3,498.96	3,498.21	5,162.07	4,599.87	52,269.79

Source: I DBI, *Report on Development Banking in India, 2000-01.*

Employment of Funds by UTI

(Rs in crores)

Type of Investment	*As on end June*									
	1997		1998		1999		*2000*		*2001*	
	Amount	*% to total*	*Amount*	*% to total*	*Amount*	*% to total*	*Amount*	*% to total*	*Amount*	*% to total*
A. In Corporate Sector										
1. Equity Shares	28,132.12	49.2	32,134.00	52.5	33,838.60	54.5	42,690.26	56.8	40,251.59	57.3
2. Preference Shares	40.00	0.1	25.00	-	127.00	0.2	430.36	0.6	467.90	0.7
3. Debentures	16,396.00	28.7	19,233.00	31.4	18,839.90	30.3	23,209.99	30.9	22,886.37	32.6
4. Advance Deposit against investment commitments	-	-	-	-	-	-	1.50	-	-	-
5. Fixed Deposits with companies	1,094.81	1.9	. 683.64	1.1	135.10	0.2	82.53	0.1	909.50	1.3
6. Application money for shares and debentures	-	-	188.10	0.3	57.00	0.1	78.67	0.1	-	-
7. Term Loans	3,308.00	5.8	2,843.00	4.6	1 ,953.80	3.1	1,577.88	2.1	922.93	1.3
Sub Total (A)	48,970.93	85.7	55,106.74	90.1	54,951.40	88.5	68,071.19	90.6	65,438.29	93.2
B) Other Investments										
8. Deposits and other investments with banks	3,649.00	6.4	3,541.00	5.8	1,870.60	3.0	1 ,985.53	2.6	151.42	0.2
9. Government Securities	4,505.00	7.9	2,517.00	4.1	5,263.60	8.5	5,102.57	6.8	4,611.87	6.6
Sub Total (B)	8,154.00	14.3	6,058.00	9.9	7,134.20	11.5	7,088.10	9.4	4,763.29	6.8
Grand Total (A + B)	57,124.93	100.0	61,164.74	100.0	62,085.60	100.0	75,159.29	100.0	70,201.58	100.0

Source: IDBI, *Report on Development Banking in India, 2000-01.*

UTI's popular open-ended equity schemes include Grand Master 1993, Master Gain 1992, Equity Tax Saving Plan, Unit Growth Scheme 10000, Master Growth Unit Scheme 1993, Master Plus 1991, Master Index Fund, and Nifty's Index Fund. The open-ended balanced schemes offered b)' UTI are Unit Scheme 1964 (US 64), US 95 Open Ended Balanced-Income Option, US 95 Open-Ended Balanced-Growth Option, Charitable and Religious Trust Societies 1981, Children's Career Plan, UTI Variable Investment Scheme, and Unit Scheme 2002. UTI also offers Money Market Fund schemes such as UTI Money Market Fund (Income Option) and UTI Money Market Fund (Growth Option).

Assistance to the Corporate Sector

The Unit Trust of India helps in industrial growth through sanctioning and disbursing assistance under project and non-project finance. It also provides to the corporate sector financial services, including underwriting to the corporate sector.

Sanctions and disbursements by UTI declined by 12.7% and 10.9%, respectively during 2000-01 (Table 17.1). The total investable funds of UTI also declined by 6.6% during 2000-01 as compared to a growth of 21.1% in the previous year. The corporate sector accounted for 93.2% of UTI's aggregate investments. UTI's investment is highest in equity (57.3%), followed by debentures (32.6%), and government securities (6.6%). UTI's total income declined by 62.8% in 2000-01, which led to a decline in the net amount transferred to revenue appropriation account. UTI's total assets declined by 1.8%, while its investments rose by 2.8% in 2000-01. The reserves and surplus turned negative during 2000-01. UTI's exposure to the equity market increased in the nineties. Since last five years, both the primary and secondary segments of the capital market are in a depressed state. The chances of generating good returns to pay high dividends have reduced. In spite of this, UTI paid high dividends to its investors from its reserves, which resulted in negative reserves of Rs 75,900 crore in 2000-01.

The Unit Trust of India has taken certain initiatives in the areas of investor service and efficient fund management. These are:

(i) making US-64 NAV-based effective January 1,2002;
(ii) disclosure of portfolio for all schemes, including US-64 on a monthly basis;
(iii) daily announcement of NAVs;
(iv) introduction of special repurchase facility with monthly increasing price support for investments up to 3,000 units per investor from August 1,2001, and up to 5,000 units per investor from January 1,2002;
(v) price support of Rs 10 per unit from May 31, 2003, for holdings in excess of 5,000 units per investor;
(vi) issue of detailed investment manual and comprehensive delegation of powers;
(vii) setting up of a Risk Management department;
(viii) setting up of Asset Reconstruction Fund for focused effort for recovery of NPAs;
(ix) performance-linked incentives for officers;
(x) commissioning of Central Processing Centre and Central Data Centre and centralisation of all back office functions;
(xi) implementation of integrated front office automation system.

US-64

UTI launched its first scheme, Unit Scheme 1964 (US-64), with the aim of inculcating the habit of saving among households. The initial sponsors of the scheme were the RBI, LIC, State Bank of India (SBI), and other scheduled banks, including a few foreign banks. They contributed-to its initial capital of Rs 5 crore. In February 1976, RBI's contribution was taken up by the IDBI. These institutions were provided representation on the Board of the Trustees of UTI. The US-64 is the flagship scheme of UTI which commands around one-fifth of UTI's total assets. Around 20 million investors have invested in the scheme. This scheme ran into trouble in 1998.

The US-64 was launched as a debt fund as the equity markets were not developed in the sixties. Its repurchase and sale price are administered, that is, fixed by UTI at the beginning of its financial year (July for UTI). Both the repurchase and sale price used to consistently increase by the end of the year, irrespective of the actual returns generated and assets under management. This administered pricing was not a problem in a bullish market but if the markets turned bearish, this high price was paid out of reserves. The government came up with a bailout package in the form of Special Unit Scheme (SUS-1999). In 1999, the UTI issued to the government special units of SUS-99 worth the book value. In turn, the government issued dated securities worth Rs 3,300 crore to take over the scrips of Public Sector Undertakings (PSU s) from US-64 scheme. The government lost Rs 1,000 crore due to the depreciation in the value of public sector undertakings stocks that were exchanged during the bailout under the SUS-99. This bailout improved the NAV of US-64 but highlighted the inherent problems of UTI such as political interventions in the investment decisions of UTI and a total lack of accountability.

UTI is governed by a special act and hence did not come under the purview of SEBI. There was no regulator to ensure the soundness of UTI's investment decisions. The small investors' interest in the scheme was mainly due to the higher returns it generated and dividends it declared and, above all, backed by the government. They were never bothered about the functioning of UTI. UTI never made it a practice to disclose any qualitative information to the investors. In fact, UTI continued to float a series of schemes with assured returns and followed liberal dividend policies. These assured return schemes with high dividend pay-out were no longer practical.

Dividend History of US-64

Date	*Dividend (in %)*	*Rights/Bonus*
30.6.91	19.50	
30.6.92	25.00	Preference offer @ 11.20 (July 1992)
30.6.93	26.00	2:5 Rights @ 12.80 (July 1993)
30.6.94	26.00	1.5 Rights @ 14.80 (September 1994)
30.6.95	26.00	1:10 Bonus Issue
30.6.96	20.00	
30.6.97	20.00	
30.6.98	20.00	
30.6.99	13.50	
30.6.00	13.75	

30.6.01	10.00	

Source: Capital Market, July 9-22, 2001.

In 1993-94, the income from the US-64 scheme was Rs 3,538 crore while the dividend outflow was Rs 3,128 crore. However, the dividend outflow started exceeding its income from the financial year 1994-95 and continued till 1996-97. In 1994-95, the dividend outflow was Rs 3,973 crore as against the income of Rs 3,287 crore. This depleted the reserves of UTI which dropped from Rs 5,842 crore in 1993-94 to Rs 1,778 crore in 1996-97 and finally turned negative by Rs 1,098 crore in 1998. With a view to building up reserves, UTI reduced its dividend rate from 20% to 13.5% in 1998-99. The 10% dividend that UTI declared in 2001 was the least dividend, it had declared in the last two decades. The scheme's equity investment had increased to 64% in the late nineties from a mere 26% in 1990. Both the primary and secondary segments of the capital market were in a depressed state, which reduced the chances of generating good returns to pay high dividends.

The government appointed a high-level committee under the chairmanship of Deepak Parekh, Chairman of HDFC, for restructuring UTI. The Committee came up with 19 suggestions which included increasing the debt component in investments of the scheme, bringing the scheme under the purview of SEBI, and the most prominent being to convert the US-64 into an NA V driven scheme within a period of three years. UTI failed to tap the opportunity of converting this scheme into NAV driven during 1999-2000 when the capital market was bullish. The failure of UTI to implement the recommendations of Deepak Parekh Committee led to an eruption of another crisis in 2001.

UTI freeze the repurchase and sale ofUS-64 units in July 2001, shattering investors' trust. On the NSE, the fund was trading far below the repurchase price of Rs 13.20 and dipped to a low of Rs 9.60 within a week. The corporates had anticipated this well in advance and withdrew their funds before the crisis struck. To help out the small investors, the government provided Rs 300 crore support to bridge the gap between NAV and the administered repurchase price of US-64 units.

The government set up a committee under the Chairmanship of former RBI Deputy Governor, S S Tarapore, to investigate into the commercial aspects and investment decisions of the fund. The Tarapore Committee called for an inquiry into more than 19 investment decisions of the Trust. It suggested creating three AMCs to handle growth funds, income funds, and Units Scheme, 64, and introducing performance-linked management. According to the committee, the UTI Bank could hold 49% of the capital of the three AMCs and this would, over time, enable greater private participation in UTI. It further recommended that only individual investors should be allowed to invest in US-64. Corporations and institutions should not be allowed to invest in US-64.

The Malegam Committee, which was formed by the Board of Trustees of UTI at the instance of the government, recommended a three-tier structure in line with SEBI regulations comprising a sponsor, a trustee company, and an Asset Management

Company (AMC). It suggested that the government should limit its stake through IDBI, SBI, and other government-backed financial institutions to 40% and the rest 60% could be offered to a sponsor or strategic partner. The Trustee company should be a fully owned subsidiary of sponsor company and shareholding of sponsor company in the AMC should be restricted to 40% with the balance to be offered to public. The Committee further recommended that the UTI Act should be repealed and replaced by a new enactment. The government must be completely distanced from UTI. US-64 should be net asset value based before restructuring of UTI is attempted. Provisions should be made for contingent liabilities, if any, arising out of the gap between the available assets of US-64 and guaranteed price to individual unit-holders owning up to 3,000 units.

In view of these recommendations, UTI took a decision to skip dividend for the first time in 2001--02 and to incorporate professionals on its board. The US-64 scheme moved to the NAV basis on January 1,2002. The US-64 NAV is hovering around Rs 6 a unit which has eroded the investors' confidence in the scheme.

In the year 2002, problems of liquidity and redemption pressures on the schemes surfaced again. Earlier it was US-64, the new problems related to 17 assured monthly income plans (MIPs) of UTI which had negative reserves. For instance, MIP 97 III had negative reserves of Rs 260.1 crore, MIP 97 IV had negative reserves of Rs 296.8 crore, MIP 97 V had negative reserves of Rs 170 crore while MIP 98 had negative reserves of Rs 296.8 crore. UTI met the redemption of the first MIP 97, which matured in June by dipping into its reserves. MIP 97 alone had a shortfall of Rs 402 crore due to the large gap between its assured redemption price of Rs 10 and the March 31, 2002, NAV of Rs 6.39. The Development Reserve Fund which guarantees its assured return schemes was pegged at about Rs 1,800 crore and the gap in its assured return schemes was in excess of Rs 3,000 crore. Seeing the financial strain of UTI, the government provided it a partial guarantee for Rs 1,000 crore. On the basis of this guarantee, UTI borrowed Rs 1,500 crore from State Bank of India (SBI) to meet its payment obligation on two monthly income plans.

The Finance Minister, Jaswant Singh, announced another bailout package for UTI. This package amounted to Rs 14,561 crore and led to UTI bifurcating into UTI-I and UTI-II. The government handed over one part, comprising the 43 net asset value based schemes (UTI-II) to a company floated by LIC, SBI, Punjab National Bank, and Bank of Baroda. UTI-II started operations from February 1, 2003. UTI-II has become a SEBI compliant mutual fund with a three-tier structure, comprising the board of trustees, sponsors, and an asset management company with a paid-up capital of Rs 10 crore. The four players have invested Rs 2.5 crore each. The government will continue to run the Rs 31,000 crore worth UTI-I, comprising the flagship scheme US-64 and other assured return schemes. The government has appointed one administrator and four advisors for the ailing UTI-I.
The government has repealed the UTI Act through an ordinance. Both UTI-I and UTI-II will comply with the requirements of SEBI. The government will issue 10-year, tax-free bonds to banks and financial institutions to raise Rs 10,000 crore to meet the shortfall in the NAV and the declared repurchase price of US64. Those bonds will carry a coupon rate of 7 to 7.5 per annum and could be redeemed in the

last three years before maturity. Dividend reinvestment option under the income plan of US-64 will be discontinued. Investors will have the option either to encash their holdings at the declared, predetermined price or to convert the existing units with assured repurchase price into NAV-based prices or to invest in the tax-free bonds. The government has assured a repurchase price of Rs 12 per unit in respect of holding up to 5,000 units and Rs 10% in respect of holding above 5,000 units and this administered price will continue even after May 2003. Dividend income from Unit-64 is tax free and profit on the sale of US-64 units is exempted from capital gains tax and dividend received in UTI-I from its investments will be passed on to the investors after administrative expenses.

GROWTH AND PERFORMANCE OF MUTUAL FUNDS IN INDIA

The Indian Mutual Fund industry has grown tremendously in the last decade. There are 34 mutual funds with assets under management of around Rs 1 lakh crore. Assets under Management (AUM) crossed Rs 1,00,000 crore during the year 1999-2000 recording a growth rate of 65%. Besides, vast majority of equity schemes out-performed the market. However, in the subsequent year, that is, 2000-01, AUM sharply declined by about 20% to Rs 90,587 crore due to extreme volatility in the market and depressed equity market conditions. The mutual fund industry witnessed such a sharp decline for the first time in the last two decades. There was a turnaround in the year 2001-02. The AUM grew by 11% to Rs 1,00,594 crore. During the year 2001-02 while there was an increase in AUM by around 11%, UTI lost more than 11% in AUM. It is evident that UTI is losing out to other private sector players. The AUM of private sector mutual funds rose by around 60% during the year 2001-02.

During the year 2001-02, 90 new schemes were launched-74 of which were open ended and 16 close ended. Income schemes predominated with 53 schemes collecting Rs 2,744 crore which accounted for 82% of total collection of Rs 3,355 crore from new schemes. Almost 96% of the money raised from new scheme launches were invested in the debt/money market. Sales under Growth, Balanced, and ELSS schemes declined during the year.

Assets under Management

(Rs in crore)

Category		1997-98	1998-99	*1999-2000*	*2000-01*	*2001-02*
1. Unit Trust of India		57,554	53,320	76,547	58,017	51 ,434
	Growth (%)	-	-7.34	+43.56	-24.21	-11.35
	% to Total	83.4	77.87	67.74	64.05	51.13
2. Bank Sponsored (4)		4,872	5,481	7,842	3,333	3,970
	Growth (%)	-	+12.5	+43.08	-57.50	+19.11
	% to Total	7.06	8.00	6.94	3.68	3.95
3. Institutions (4)		2,472	2,811	3,570	3,507	4,234
	Growth (%)	-	+13.71	+27.00	-1.76	+20.73
	% to Total	3.58	4.11	3.16	3.87	4.21
4. Private Sector		4,086	6,860	25,046	25,730	40,956
	(a + b + c)	-	+67.90	+265.10	+2.73	+59.18

% to Total		5.90	10.02	22.16	28.40	40.71
	(a) Indian (7)	1,031	1,016	2,331	3,370	5,177
	Growth (%)	-	-1.50	129.43	+44.57	+53.62
	% to Total	1.50	1.48	2.06	3.72	5.15
(b) JV-Predominantly						
	Indian (8)	1,583	3,040	9,724	8,620	15,502
	Growth (%)	-	+92.04	+219.87	-11.35	+79.84
	% to Total	2.30	4.44	8.60	9.52	15.41
(c) JV-Predominantly						
	Foreign (10)	1,472	2,804	12,991	13,740	20,277
	Growth (%)	-	+90.5	+363.30	+5.77	+47.58
	% to total	2.13	4.10	11.50	15.17	20.16
Total (1 + 2 + 3 + 4)		68,984	68,472	1,13,005	90,587	1 ,00,594
Growth (%)		-	-0.75	+65.04	-19.84	+ 11.05
Total	100.00	100.0	100.0	100.0	100.0	100.00

Note: Figures in brackets denote number of funds. *Source:* AMFI

CONCLUSION

In India, mutual funds have a lot of potential to grow. Mutual fund companies have to crate and market innovative products and frame distinct marketing strategies. Product innovation will be one of the key determinants of success. The mutual fund industry has to bring many innovative concepts such as high yield bond funds, principal protected funds, long short funds, arbitrate funds, dynamic funds, precious metal funds, and so on. The penetration of mutual funds can be increased through investor education, providing investor oriented value added services, and innovative distribution channels. Mutual funds have failed during the bearish market conditions. To sell successfully during the bear market, there is need to educate investors about risk-adjusted return and total portfolio return to enable them to take informed decision. Mutual funds need to develop a wide distribution network to increase its reach and tap investments from all corners and segments. Increased use of internet and development of alternative channels such as financial advisors can play a vital role increasing the penetration of mutual funds. Mutual funds have come a long way, but a lot more can be done.

Threats to Mutual Funds posed by E-broking

Equity markets for a long time were a bastion for institutional investors and high net worth individuals only. The high risk-return profile of equity investments was an attraction for retail investors as well. But it was only with the advent of mutual funds that they entered the stock markets in a big way. Mutual funds in India, and all over the world, have been a hit with small investors. They have provided a better yielding avenue to such investors who want to invest in the stock markets, but are not backed by substantial savings to do so. Earlier investors had to buy a minimum of 5,10, 50 and 100 shares, depending on the face value and the company, if they made an investment in the equity markets, and this foreboded small middle class investors whose requirement was to make investment out of their small savings. Though the situation has changed now, with dematerialization of shares, allowing investors to buy

and sell a single share, the high prices of a few shares like Infosys, and Wipro don't allow the investors to take advantage of such attractive investments. But trading of fractional share, as has been already permitted in the US, will do away with that constraint too.

Internet trading in stocks eliminates the hassles of running around the broker, uncertainty over the exact price of purchase, writing out cheques and giving instructions to depository participants (a broker with a demat account). An investor can do his own research on the Net before making a deal. The websites offering e-broking have all the information needed to make an informed purchase or sale. Till recently, such information was the exclusive preserve of big investors. *Internet trading in India is expected to account for 10 per cent of the trading volume of the stock exchanges in a year and would grow to 25 to 30 per cent in the next few years.*

The sale or purchase of shares involve three steps: placement of order (for sale or purchase), payment (for purchase) and delivery of shares. Since payments through the Internet are not yet legally valid in India, for most small investors e-trading is currently restricted to the placement of order. However, once cyber laws are passed by Parliament -- which is likely to happen in a couple of months -- entire trading could happen online. Says D.R. Mehta, chairman of the Securities and Exchange Board of India (SEBI): "The complete cycle of Internet trading, from booking orders to payments, will go online only after cyber laws are passed by Parliament."
A mutual fund is a corporation, which pools together investor's money, and buys stocks or bonds on their behalf. Investors participate in it by purchasing shares of the entire pool of assets, to diversify their investments. The Capital gains or dividends from these securities are then distributed to unit holders or the investors of the Fund.

Mutual funds in India were brought in by the government in 1964 as UTI, the largest mutual fund in the country, to encourage small investors in the equity market. UTI has an extensive marketing network of over 35, 000 agents spread over the country. The UTI funds have performed relatively well in the market, as compared to the Sensex trend. However, the same cannot be said of all mutual funds.
Nowadays, an average person / investor is more aware and educated about the equity markets than ever before. The stock markets have become a regular topic of discussion in many parties. Hence, the advantage that mutual funds provided of the fund manager's expertise in investing, is no longer the mutual funds' selling proposition. *The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US-64 scheme.* The

Indian public are largely unaware of the nuances of mutual fund schemes. This debacle proved that even fund managers who should know better get swayed by movements in capital markets and take investment decisions which go awry when the mood in the market changes. Though this scheme was bailed out with considerable cost to exchequer, not every mutual fund may be as big and fortunate that the government has no option but to bail out the scheme, as UTI. We will know over the next few years whether UTI will be able to regain the almost blind faith that investors had reposed in the institution. Another factor that may adversely affect UTI is the expected demise of regular income schemes wherein the returns are guaranteed. Many

funds currently have NAV less than the face value, partly reflective of the fact that mutual funds are not as fool proof as was earlier believed.

Hence, investors have to be careful with their investment decisions, as they are not guaranteed by the Government, Reserve Bank of India or any other government agency. Number of such schemes have run into trouble, and though mutual fund industry is in the growth phase, with many new entrants and mergers between existing players, investors need to keep a wary eye on developments as their own money is involved.
Most people invest in mutual funds for one simple reason. They are a convenient and cost effective method of obtaining diversification and professional management. The risk factor is also considerably low. This is because mutual funds hold anywhere from a few securities to several thousand, over a number of investments. What's more, mutual funds generally buy and sell securities in volume, which allow investors to benefit from lower trading, management and research costs.

It is also felt that many investors invest in MFs more for convenience than to avail themselves of the fund managers' expertise. Studies in the US show that well-managed funds get good inflows of money and grow rapidly, though interestingly, poorly managed funds, while not getting funds, also did not lose money. This is indicative of a built-in inertia in the investors' attitude. With folio services like allowing the investor to buy fractional shares, trade execution and accounting function of a MF can be automated and become very convenient for investors. Since providing these services is not expensive, one might see these functions becoming highly commoditised. And in the demat environment, there is no reason why fractional shares cannot be processed. With technology, today an investor also has access to key information, which was earlier only a manager's privilege. Investors maybe more inclined to invest in select portfolios rather than to go by the MF route.

The table shows the investments in Mutual Funds, with the break-up in various schemes.
Fund Mobilization (august'2000)

Sale							
New scheme	Existing scheme	Total					
A Unit Trust of India	1	0.4	6.1	6.5	10.3	-3.8	671.9
B Bank Sponsored (7)	-	-	1.2	1.2	1.6	-0.4	63.7
C Institutions (4)	-	-	1	1	1.2	-0.2	30.1
D Private sector							
I Indian (5)	-	-	21.7	21.7	9.5	12.2	38.4
II Joint Venture:							

Predominantly Indian (7)	-	-	8.1	8.1	10.2	-2.1	90.8
III Joint Venture:							
Predominantly Foreign (9)	2	0.4	31.2	31.6	30.6	1	133.6
TOTAL (I+II+III)	2	0.4	61	61.4	50.3	11.1	262.7
Grand Total (A+B+C+D)	3	0.8	69.3	70.1	63.4	6.7	1029

Though the spread of the Internet has been slow in India, players are catching on fast, at least in the online stock trading business. Internet trading or e-broking seems to have passed through its teething troubles and more players are now entering the fray. Given the suitability of the product and rising demand, therefore, it is no surprise that E-broking has captivated the imagination of the consumer and created a new breed of investor - the day-trader -whose impulse to buy, own and sell is, and must be, matched by swift transaction processes. Online brokerage houses aim to provide real-time quality information and research, high transaction efficiency and customer service. This include stock analysis tools like technical analysis charts provided by ICICIdirect, stock tips, latest research reports, company analysis, trends in the market, real-time market commentary, market scoops and breaks etc. all these tools will help in making the investor better informed and better equipped to make intelligent investments.

While volumes are still low at the Rs 100 million a day mark compared to the combined turnover of Rs 90 billion a day on the Bombay Stock Exchange and the National Stock Exchange, e-brokers have already announced price cuts that have been unheard of for the Indian trader. Investors and traders have never had it so good as trading commissions and brokerage rates are declining steeply. E-broking has triggered off a price war with each player valiantly trying to outdo the other. Every broker has offered a service or a price to differentiate itself from the rest of the fray.
Online brokerage houses in India might offer folio services sooner than most people expected. It is predicted that with net trading becoming important, we could be a year away from active trading. And another year away from online traders moving into sophisticated activities like folio services.

Online brokerage houses abroad are already offering folio services. Foliofn.com, a foreign online brokerage firm, for instance, allows its investors to buy fractional shares and treats a portfolio trade as a single order. Unlike the conventional portfolio management services, these are less expensive. These are charged like any other stock trading services.
While substantial progress has been made by stock exchanges and SEBI with screen based trading and dematerialization, a typical retail investors still feels the pinch of high brokerage. With his regular broker, sitting in and brick and mortar set-up , he did not have access to real time, quality research and information. E-broking is yet another milestone in trading, which has substantially reduces brokerage charges and

transaction costs to the investors. The online brokerage houses play on volumes, not margins and brokerage.

Flexible systems with high levels of connectivity are vital to e-broking. But with increasing bandwidth and laying of optical fibres for transmission of data, this problem will also solved.
Traditional broking was previously a personalised industry with individual brokers operating through firms. Then the business went through a process of corporatisation.

According to Forrester Research, by 2003, 9.7 million US households will manage more than $3 trillion in 20.4 million on-line accounts. Jupiter Communications estimates that, by 2003, 20.3 million households will trade on-line and also puts total on-line account assets at more than $3 trillion.
Professional Management
Mutual Funds provide the services of experienced and skilled professionals, backed by a dedicated investment research team that analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme. But the failure of many mutual funds in the past has proved that even fund managers are not fully immune to market vagaries despite their knowledge and experience. Further with the regulation of sharing all information given to analysts,with the general public, the information edge of the institutions has disappeared.
Diversification

Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. Investors can achieve this diversification through a Mutual Fund with far less money than they can on their own. But sector based funds like Birla IT fund, Kotak Mahindra K Technology, Kothari Pioneer Pharma fund- have been very polular with investors, indicating their willingness to take exposure in a specific sector to reap the benefits if high growth rate of the sector, hence achieving high returns.

Here, mutual fund does score over the online brokerage but in recent times investors have referred high returns to diversification.
Return Potential
Over a medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities. But for short term investors, mutual funds are not such an attractive avenue. Here online brokerage houses havea big advantage over the mutual funds. They have led to the birth of a new class of investors hitherto unknown in India: day traders.
Low Costs
Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors. There is 1% expense fee levied in the investment, along with custodial, asset management and other fees. But with the brokerages falling through the roof the ost advantage of mutual funds is also lost. Online brokerages in Inda are among the lowest the world over.
Liquidity

In open-end schemes, the investor gets the money back promptly at net asset value related prices from the Mutual Fund. In closed-end schemes, the units can be sold on a stock exchange at the prevailing market price or the investor can avail of the facility of direct repurchase at NAV related prices by the Mutual Fund, though very few close ended schemes are in existence now. Trading in open-ended schemes is not an issue as they can be sold to the scheme itself anytime the investor wants to liquidate his position. But with online broking, and dematerialised environment in the capital markets now, liquidity of stocks is no more a problem.

Transparency
Though mutual fund managers promise regular information on the value of the investment in addition to disclosure on the specific investments made by the scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook, this has not been a common practice. The example of UTI illustrates this point. This works as a big disincetive to the people planning to invest in mutual funds.

Flexibility
Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, investor can systematically invest or withdraw funds according to his needs and convenience in mutual funds. But what more ease then to do the trade yourself without any human interaction. Online brokerage offers you the service of being able to do all the trading as per your own wishes without any human interface.

Affordability
Investors individually may lack sufficient funds to invest in high-grade stocks. A mutual fund because of its large corpus allows even a small investor to take the benefit of its investment strategy.
Choice of Schemes

Mutual Funds offer a family of schemes to suit your varying needs over a lifetime. There is a variety of schemes available like Gilt funds, equity linked saving schemes, sector funds, income funds, balanced funds etc. This is a big advantage and investors can match the type of schemes to their risk profiles, liquidity preference and interests.
Therefore, if one online broker starts providing these services at low cost, others could follow suit since online broking is very competitive. The costs to a broker to provide these services through a software program in computer and with the prices of computer and its products getting cheaper by the day, are not a barrier. Online banks might also enter the fray. This kind of business models of folio services abroad have recently started and are still in their infancy. The MFs will have to be on their toes. If a MF is concentrating on the functions that can be automated, they might see a decline in their revenues. Therefore they should concentrate on functions, which cannot be automated.

Now looking at an MF, their core function is fund management and the other functions are trade execution and accounting functions. A prudent MF should focus more on fund management and become knowledge-intensive. Personal relationship

with high networth clients is another area where technology cannot pose a big threat. Wherever technology has a potential to reduce cost, MFs will have to use it.
The ease of setting up on-line broking operations has driven down commissions. Even though online brokerage houses are making losses in the short run, they are confident of the future of e-broking. Also, most of the online brokerage houses have been set up by existing brick-and-mortar brokers, to supplement their existing business and increase their reach. Currently, Indian broking firms charge an average of 0.85 to 1.25 per cent as commission, which is lower than in many other markets.

The fierce competition in on-line broking and the increase in trading volumes are certain to drive these rates down further. The transaction costs will be significantly lower. The first clutch of brokers are charging between 0.75 per cent and 0.40 percent for delivery trades depending on the size of transactions.
The discount brokers
ICICI Direct (www.icicidirect.com) was the first broker to introduce a brokerage of 0.85 per cent per trade. ICICI's differentiators are an integrated service encompassing broking, banking and depository services from ICICI Bank. ICICI Direct's pricing structure depends on how much the investor trades and ranges between 0.85 per cent and 0.4 per cent as trade volumes increase.

In July, Probity's 5paisa (www.5paisa.com) was the next one introducing a brokerage rate, probably the lowest in India, of 0.05 per cent a trade. Last week, stockbroker S S Kantilal Ishwarlal's Sharekhan (www.sharekhan.com) turned the fee structure of the broking industry upside down in July by introducing a trade-as-much-as-you-want scheme of Rs 1,000 a month. Sharekhan is the first broker in the country to introduce flat-fee broking. On August 9, Kotak Securities introduced e-broking with the option of trading against securities. Other players will inevitably introduce further innovations in the near future.

Apparently, Sharekhan is targeting the high volume trader with its fee structure that is not a percentage of transaction value. If a trader crosses monthly volumes of Rs 2 million, Sharekhan is the cheapest broker. (At a volume of Rs 2 million, the 5paisa.com brokerage works out to Rs 1,000.) Reacting to the cut-rate discounts, ICICI Direct has reduced its minimum brokerage per trade from Rs 100 to Rs 25 and the minimum trade size from Rs 6,000 to Rs 1,000.
Each player is supremely confident of the success of his respective pricing strategy and revenue model, even though the services they are offering at such attractive rates sem impractical and unsustainable. Only time will tell whether the confidence is misplaced or not.

All the online brokers are targeting large volumes of trade to make money. While some of them admit they will make losses in the short-term, they remain optimistic about overcoming them with sufficient volumes.
To survive, brokers must specialise, diversify, or face being swallowed by retail banks or sunk by market forces. Thus, successful on-line brokers may be the ones that are niche providers, aiming their specialised products at highly profitable segments like high net worth active traders or, alternatively, those who decide to become infomediaries, offering a wide range of products and services. The winners will be

those brokerage houses that provide an entire spectrum of products and services for the investor, and have the technology to scale up their systems to cope with the increasing volumes of trades on-line.

The stock exchanges too are gearing up their infrastructure to facilitate Internet trading. The NSE has not just put a comprehensive e-trading system in place, it is in the process of connecting the system to the bank interface for online payments. The stock exchange of Mumbai (erstwhile BSE) is in the process of finalising its e-trading module and has informed its 300 member-brokers of the rules for Net trading prescribed by SEBI. Says M. Vaishya, director in charge of e-trading in BSE: "Internet trading will lead to a tremendous spurt in the total trading volumes, involving wider retail participation. "

The outpouring of small investor interest testifies that. The website of Motilal Oswal Securities, one of the firms licensed to provide online broking, gets 7,000-8,000 enquiries a month about online trading. This shows the rising interest of retail investors in using the facility of e-broking. The firm expects at least 25 per cent of these enquiries to convert into clients. The investors will gain from a fall in brokerage fee from 1-2 per cent (of the purchase or sale deal) to just 0.75 per cent. E-broking will take the stock markets right to the small investors' doorstep.

But the real winner in the cyber-broking sweepstakes will, of course, be the investor who can, more easily than ever before, not only know where to put his money, but when and why. And all of this with just a few clicks of the mouse.
In smaller towns another trend has been observed. In smaller towns like Kota etc., brokers charge on an average of 5% brokerage. Now, the investors are taking advantage of on-line broking. To give an example, a few shopkeepers together hire a person who does nothing but place orders through an on-line account for this group of people. He is paid say about 2% charge on the trades, additional to the online brokerage of about .85% (inclusive of transaction fee). Still the brokerage charges workout to be much lower than the traditional broker.

In most cases of online brokerage houses, only one leg is e-enabled.i.e. only order placement and execution is carried out through the internet (the customer logs on to the broker's website to check share prices and related information. He then places a purchase order through authorised secure user id and password. Order is routed through the broker to the stock-exchange server and he gets confirmation of the deal in a few minutes.) . But the payment is not. They payment for the securities, and delivery of shares, has to be collected the traditional way. Payment for the securities as of now is not being taken through credit cards. This may be to curb speculation during the credit period. Also the merchant, in this case the brokerage house, will have to pay a fee (about 2%) to the card issuer bank, which will increase their costs.

In US both legs are e-enabled on most cases. For example for Indiabulls, the investor places his order online in real-time, and the execution of his order is carried out. The investor, incase he does not have an existing savings account, is required to open an account with UTI Bank, Barakhamba Branch. Another route Indiabulls has been following is that when the Delhi-based customer takes delivery of shares, Indiabulls

sends its representative to the customer within an hour to collect the payment, whether in cash or cheque. The credibility of the customer is verified before he is allotted his trading account with Indiabulls, by verifying his saving bank statement, ration card, passport, license etc. to validate his identity. Which means that the active trader has to be located in Delhi or else he cant trade on a daily basis. Once payment on the Internet is allowed, payment amount will get deducted from the investor's online bank account (with which the broker has tied up). The purchased shares will be credited to the online demat account in no time.

Only ICICI (with ICICIdirect) and HDFC (which will soon start its online broking facility) have an advantage in this aspect, having both legs e-enabled, since they have a strong backbone with payment gateways, as they are networked with other banks. Thus even investors based in smaller towns can use their brokerage services.
Right now only ICICIDirect has the infrastructure to provide complete online trading on the Net to retail investors. It has a broking arm, an online banking facility which offers demat account for trading in shares. ICICIDirect allows it's customers to have an account with any bank and allows them to take maximum exposure equal to the amount they have in their account. The client first opens a brokerage account with

ICICIDirect by filling a form online and paying a fee, which ranges from Rs 550 to Rs 800. Opening a brokerage account entitles the client to a savings bank account and a demat account (required for trading in demat -- paperless -- shares). With these three accounts, the investor can place the order for purchase or sale, pay from his online account and get the transaction credited to his demat account.
Regulatory issues:
All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI. Broker, on the other hand, can invest as he pleases

Conclusion

Hence, an informed investor who is looking for convenience in active day trading will find online brokerage services of great use. But investors looking for medium term an long tem horizons may still be willing to put their money in hands of mutual fund managers or investing through their local brokers.
The mode of payment and fund transfer still remains an issue to be tackled in e-broking.

Best Funds 2004

Find out where your scheme stands in our comprehensive annual ranking of mutual funds
Kayezad E. Adajania, 16 Mar 2004
IF YOU'D gotten on board a mutual fund to trawl the financial markets through 2003, you probably enjoyed the ride. Chances are you'd be smug in the knowledge that your investments have gone far–farther than you probably expected. In the short history of mutual funds in the country, last year was one of the best ever. They were helped, in

no small measure, by the favourable conditions in the two financial markets. The stock market staged a smart rally on the strength of attractive valuations, strong economic growth, encouraging corporate results and foreign funds. The debt market too offered ample opportunity to maximise gains, and though returns were lower than the year before, they were reasonable.
Endings and beginnings. Amid the euphoria over an outstanding year, many events of importance to the mutual fund industry slipped by. The revamp of UTI, the country's largest mutual fund, was finally completed. In other endings, Zurich Mutual Fund sold out to HDFC Mutual Fund and IL&FS is in the process of being acquired by UTI, continuing the process of consolidation in the industry.

Meanwhile, two global financial powerhouses, HSBC and Deutsche Bank, entered the fray, and word is that ABN-Amro and Fidelity are likely to soon follow suit. As the industry continues to evolve, so does its bouquet of products. Several new kinds of schemes hit the market–floating rate income funds, bond index funds and funds of funds. This year, we've seen funds dedicated to international stocks being launched and now there's talk of assured return funds. Mandatory certification for distributors to sell mutual funds and more stringent pricing norms made mutual fund buying and selling more fair and transparent.
But let's move on to the real point of interest here: performance. When it comes to mutual funds, a year-end is not the finishing line, it merely signals the end of a period of time. But it's also a good time to take stock, of how good or bad the journey this far has been, of whether to continue on the existing path or to make mid-course corrections. Just how did your scheme fare in 2003, in relation to the market conditions it had to operate under and its peers? Who were the toppers in the eight fund categories? What's the outlook in 2004 for the various kinds of schemes? Which schemes should you board and which ones should you desert? The answers are all there in Outlook Money's annual ranking of mutual funds in the country.

EQUITY FUNDS Full steam ahead

Without doubt, 2003 was the Year of the Bull. There were many factors that made the market's turnaround sweet and memorable for investors. It is after three-and-a-half long, sometimes bitter, years that the market is shining again. It wasn't the least bit expected to go up this fast, this soon. And from the look of things, it's not a flash in the pan either. This is not a rally that's riding the next new faddish sector; it is broadbased and looks set to endure.

The BSE (Bombay Stock Exchange) Sensex–the commonly used benchmark to assess the performance of equity funds–rose 70 per cent in 2003. By comparison, actively managed equity funds, on average, returned 102 per cent. Fund managers picked their stocks well, used the rising market to churn portfolios, all in an attempt to beat the market. Commendably, many managed that with elan.
Making money from the market in 2004 won't be as easy as last year, widespread opinion says. Says Rajat Jain, chief investment officer, Principal India Mutual Fund:

"We expect equity to return 15 per cent in 2004." Although the market has run up and is presently locked into a narrow range, it still has plenty going for it. Market players say foreign funds are keen to invest more, political uncertainty is dismissed as a non-

factor, as the BJP is expected to win hands down. The key to the market's growth lies in sustaining the current rate of economic and corporate growth, continuing with reforms, and withstanding competition from other emerging Asian economies. The outlook for equities remains positive. Even if the market moves in a narrow range, well-managed diversified funds should deliver decent returns.

Diversified equity funds. One statistic tells just how rewarding–and easy–a year it was for diversified equity funds. Of the 44 schemes that made our cut, just one, GIC

Growth Plus II, failed to beat the Sensex, that too only just. As a group, diversified equity funds gained 110 per cent, which lifted their five-year averages. For instance, our top-performing fund, Reliance Vision Fund, on the strength of 155 per cent jump in NAV, boosted its five-year average from 18.6 per cent in 2003 to 45.5 per cent this year. Just goes to show how one good year can compensate for a few bad ones, and why we keep iterating that stocks have to be seen as long-term investments, not short-term flings.

The usual suspects–Templeton and HDFC schemes–feature prominently at the top. Diversified funds that ventured beyond the index and large-cap stocks gained the most. Like Franklin India Prima Fund, which returned 177 per cent last year alone. Or, the topper, Reliance Vision. Sometime in 2002, this fund took to mid-cap stocks. Says Madhusudan Kela, head-equity management: "We buy out-of-fashion stocks because that's when we'll get the right valuations." As it turned out, Reliance Vision timed its entry well, as mid-caps stocks started rising soon after and continued into 2003–the S&P CNX Midcap gained 134 per cent that year.

Every fund can ride a good market. Often, it's how it does in sluggish and bad markets that shows its mettle, which is borne out in the five-year averages. The compounded annual returns range from -3.2 per cent (Franklin India Vista Fund) to 46.5 per cent (ironically, another Templeton fund, Franklin India Prima Fund). While choosing a scheme, give more weight to a fund's performance over many years and many kinds of markets, rather than go by just the immediate period of reference.

Outlook 2004: upside: 15-20 per cent downside: 5-10 per cent

Equity-linked savings schemes (ELSS). The performance of ELSS was much on the same lines as diversified equity funds–strong returns during the year, propping up five-year averages. HDFC Tax Saver, formerly Zurich Tax Saver, retained its top position–the only fund to do so in the eight categories. Part of the credit should go to Zurich, and Chirag Setalvad, the scheme's new fund manager, agrees. Having said that, HDFC's good record in equities augurs well for the scheme.

If HDFC-Zurich is an example of how to manage a transition, Sun F&C's takeover of the two Jardine Fleming schemes bring out the ugly side of mergers and acquisitions in mutual funds. Take Sun F&C Personal Tax Saver, formerly JF Personal Tax Saver.

Since its inception in 1996 till it was taken over in August 2002, it returned a strong compounded annual 28 per cent. Things changed after coming into Sun F&C's fold (minus its fund manager)–the fund has consistently underperformed its peers. And though it comes in it at number four, it's more a legacy of the past. Good reason to review your investment in a fund when it changes hands.

ELSS, by its very nature, is different from conventional diversified funds, in two ways. One, if your annual income is up to Rs 5 lakh, investments in an ELSS up to Rs 10,000 a year entitle you to a tax rebate under Section 88. Two, investments in an ELSS are subject to a lock-in of three years, which helps fund managers plan portfolios with a relatively longer horizon in mind. If you are inclined towards equities and need to save tax, maxing your ELSS limit in a good scheme remains a worthwhile proposition, especially when the market is down.

Outlook 2004: upside: 15-20 per cent; downside: 5-10 per cent
Sector funds. In a deviation from the past, instead of looking at all sector funds (dedicated to whichever sector) under a single umbrella, starting this year, we have segregated them further on the basis of sectors they invest in; funds that have an interest in multiple sectors or whose target investment is ambiguous have been classified under 'others'.

The extremes in performance of sector funds–lowest one-year return: 37.4 per cent (Franklin Infotech) and highest: 154 per cent (Alliance Basic Industries)–underline their inherently risky profile, and lend credence to the view that they are meant only for the savvy investor. Oil and gas funds again struck it rich in 2003, as the government flip-flop on divestment in oil PSUs kept investor interest in these stocks alive. More action is expected in this sector this year, as the PSU divestment gathers momentum.
Generally speaking, though, there weren't many hot sector stories happening. Pharma had another solid year, while FMCG was a letdown yet again. The outlook for both these sectors remains the same as their performances last year. Pharma companies are moving up the value chain and making inroads into new markets, which bodes well for them. FMCG companies, meanwhile, are fighting weak demand, rising competition from small players and severe price undercutting.

Seen against a backdrop of a racy market, technology funds disappointed. The topper among IT funds, Tata Life Sciences & Technology Fund, did deliver a one-year return of 120 per cent and a three-year return of 25.9 per cent, but it did something other IT funds didn't do. It ventured into non-IT stocks, which helped. Later this month, another IT fund, Franklin India Internet Opportunities Fund, will convert itself to a diversified fund. Most IT funds were launched at the height of the IT boom, and so continue to languish on a three-year return basis. Looking ahead, prospects for IT sector look good, though how soon it will trickle down to valuations is hard to say.

DEBT FUNDS Slow and steady
Last year's performance of debt funds, when read along with the happenings unfolding in the debt market, merely confirms what we've been saying for a while: the party is over. Equity-like returns of 15, 20, 25 per cent a year from debt funds are now a statistic, not a realistic expectation. It comes back to that oft-mentioned inverse relationship between interest rates and bond prices. When interest rates fall, bond prices go up, and vice versa. For some years now, noticeably since July 2000, interest rates have been spiralling downwards, resulting in extraordinary gains for debt funds. But now, market players feel we're in for a period of lull, a period of small cuts or small rises, if at all. No more jumps in bond prices and debt fund NAVs.

Returns from debt funds are expected to track returns from the instruments they choose to invest in more closely than before. To some extent, this trend set in last year itself. Income funds, as a group, returned 8.3 per cent in 2003, half of the 16.7 per cent they delivered in 2002. Lower, stable interest rates impacted performance of gilt funds (down from 16 per cent to 10 per cent) and liquid funds (7.2 per cent to 5.3 per cent) also, though it's still fairly good value for your savings in the present environment of falling interest rates.

Income funds. A majority of three-, four- and five-star income funds handled the tricky investment conditions prevailing in the debt market well, returning 7-9 per cent last year. Their three-year returns made for outstanding reading, thanks to buoyancy from previous years. Even amid such constancy, there was change aplenty on the upper echelons. None of the top five schemes of last year–JM Income, K Bond Wholesale, Sundaram Bond Saver, Chola Triple Ace, and Templeton Income–made it back. However, this had less to do with their performance, which was fairly respectable, and more to do with the volatility in their return patterns.
PNB Debt Fund was a surprise winner, jumping 20 places. Its secret of success: an aggressive strategy that revolved around holding an unusually large chunk of its corpus in government securities (G-secs). Typically, income funds have been seen to invest up to 35 per cent of their corpus in G-secs and the balance in corporate paper. PNB Debt Fund, however, loaded its portfolio with gilts–87 per cent, as of 31 December 2003. Although interest earnings from corporate debt is more than G-secs, the latter are more actively traded and show greater volatility, thus presenting investors with more opportunities to make trading gains. The magnitude of change also tends to be more pronounced in G-secs.

Among income funds, PNB Debt Fund was pretty much a lone ranger in stocking up on gilts. Explains fund manager S.K. Zutshi: "Bonds these days give 5-5.5 per cent, the same as gilts. So, why should I invest in bonds? Moreover, not many bonds are actively traded and they also carry some default risk, which gilts don't." The high returns given by Escorts Income Bond and Cancigo need to be qualified: nothing exceptional about their fund management, the high returns are due to the write-back of previously non-performing assets or investments in stocks.
Given the expectations that interest rates will hold, or rise a tad, a gilt-driven strategy may not be the prudent option for income funds this year. Those inclined towards greater safety should board income funds with a minority, not majority, gilt holding. Currently, the highest-safety, five-year corporate paper trades at a yield of around 5.7 per cent. At worst, an income fund should match that; at best, it should earn a handful of percentage points on account of trading gains.

Outlook 2004: 6-9 per cent.
Gilt funds. Aided by the downward push in interest rates and marked volatility in government debt paper, gilt funds outperformed close cousin income funds handsomely. While the best income fund gave 9.6 per cent, the top seven gilt funds delivered 11-16 per cent. Alliance Government Securities Fund (LT) came out on top. Badrish Kulhalli, its fund manager, attributes his scheme's success to a small corpus of Rs 13.6 crore, which is a fraction of the Rs 183 crore average among gilt funds. With liquidity in the debt market drying up, a smaller corpus meant the fund was able

to react quickly to market events and moves–crucial in a price-sensitive and finely-priced marketplace like the debt mart. Explains Kulhalli: "Many big-sized funds find it difficult to change their maturity profile when interest rates rise or fall. By the time they manage to do so, the interest rate movement is over."
Kulhalli feels that for gilt funds, corpus size will be a bigger factor this year, as interest rates are expected to float within a narrow band of a percentage point. There might be merit in having a small corpus, but that alone doesn't guarantee success for a gilt fund. Quality of fund management remains the biggest, and irreplaceable, virtue. It's why the top seven funds delivered an above-average return. It's why Tata Gilt Securities Fund made 15 positions over last year to slide into the second spot. It's also why a middle-of-the-road scheme like Sundaram Gilt Fund earned an embarrassing 4 per cent over the past year and 6.3 per cent over the past two years: inexplicably it holds 80 per cent in a single security.
Compared to last year, the risk in gilt funds has increased. They will probably have to manage greater volatility in the days to come, and risk management could well determine who sinks and who swims. If you're looking for lower returns volatility, consider switching to an income fund invested in high-rated paper.

Outlook 2004: 6-8 per cent
Liquid funds. Liquid funds aim to return more than short-term bank deposits while offering an instant, hassle-free, zero-cost exit. To that extent, liquid funds have stayed faithful to their mandate, and delivered. Most funds returned between 5 per cent and 6 per cent–1-2 percentage points more than what banks offer on similar tenures. There's little to choose between the top liquid funds. Two relatively new funds–First India Liquid Fund and Canliquid–occupied the top slots, but by a wafer-thin margin over the subsequent 12 funds.
Generally speaking, since liquid funds are separated by fractional returns, they are trying to squeeze out whatever they can from their investments. Devendra Nevgi, vice-president and fund manager (fixed income), First India Liquid Fund, attributes his fund's good showing to strong cash management skills. In functional terms, this means having adequate cash to meet daily redemptions, but also not holding more than necessary as this cash earns nothing and returns then start to suffer. Says Nevgi: "What's the point in locking money for 90 days if an investor demands his money back after 45 days?" Other liquid funds are also optimising their cash holdings, in some form or the other, in varying degrees.
Since 2000, due to the declining trend in interest rates, average returns of liquid funds have been falling 1-2 percentage points every year. This year, also, their returns range is likely to see a drop-down, though of a smaller magnitude than in previous years.

Outlook 2004: 4-5.5 per cent

BALANCED FUNDS A fine balance Helped by the strong stocks showing, balanced funds turned in a strong performance in 2003, with the average being 55 per cent. Most balanced funds skewed their portfolio towards equities, going up to 75 per cent. The debt-equity allocation influenced, in part, the performance of balanced funds–typically, greater the equity holding, greater the returns. For example, Templeton India Pension Plan, a debt-oriented fund returned 42.2 per cent in 2003, while HDFC Prudence, an equity-oriented scheme gave 92 per cent. Of course, quality of fund

management also played its part, with funds like HDFC eking out extra returns through active fund management.

Principal Child Benefit Fund, a children's plan, occupied the top position. Its one-year returns don't stand up against many others of its ilk, but it scores top marks for low volatility and consistency in returns over a three-year period, which explains its top ranking. This year too, equities should drive returns of balanced funds. The schemes in the market offer a range of equity exposure - typically between 50 per cent and 75 per cent. Keep your risk profile in mind while choosing your asset allocation.
Outlook 2004: upside: 12 per cent; downside: 10 per cent
MIPs Turnaround story

Monthly income plans are back in demand, thanks to a favourable confluence of investment conditions. MIPs load up on debt, but also park some of their corpus–up to 30 per cent–in stocks to add pop to returns. When share prices were down, MIPs found it difficult to consistently pay dividends at levels expected of a debt fund, and they fell out of favour. But with the market rising, and equity not perceived to be as risky as before, MIPs began to be looked at as an alternative to income funds–more rewarding, without a significant increase in risk.
MIPs, as a group, gained 13.1 per cent last year. Although Alliance Monthly Income, with its high equity holding, gave the highest one-year return of 20.1 per cent, the top honours went to Birla MIP Plan C for its consistency. Says fund manager K. Ramanathan: "The equity component means there's already a price risk in the portfolio. So, we play it safe with debt, investing mostly in high-safety paper with a low maturity profile." Adds co-fund manager A. Balasubramanian, who manages the scheme's equity portion: "We cap our sector exposure at 20 per cent of our equity portfolio." The three MIPs that yielded mid single-digit returns were debt-biased plans.
The present debt-equity nature of MIPs is not the ideal mix if you seek steady monthly income, as the uncertain nature of equities could mean some absentee periods and shortfalls. But if you are looking to cash in on prevailing investment conditions without stretching yourself unduly on risk, they are worth a look-see.

Outlook 2004: 8-10 per cent;

History of the Indian Mutual Fund Industry

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank the. The history of mutual funds in India can be broadly divided into four distinct phases
First Phase – 1964-87

Unit Trust of India (UTI) was established on 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by

UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6,700 crores of assets under management.

Second Phase – 1987-1993 (Entry of Public Sector Funds)
1987 marked the entry of non- UTI, public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non- UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990. At the end of 1993, the mutual fund industry had assets under management of Rs.47,004 crores.

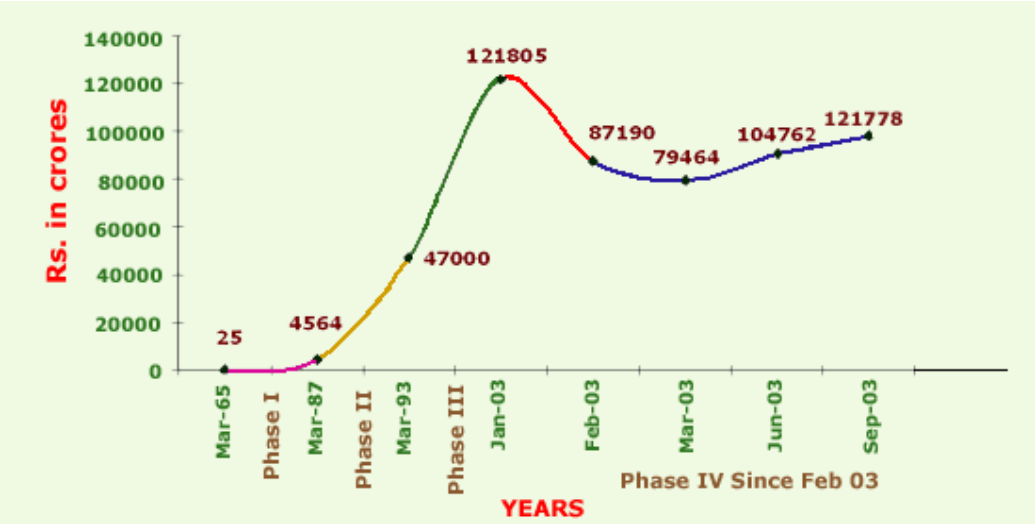
Third Phase – 1993-2003 (Entry of Private Sector Funds)
With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.
The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996.

The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crores. The Unit Trust of India with Rs.44,541 crores of assets under management was way ahead of other mutual funds.

Fourth Phase – since February 2003
In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs.29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs.76,000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. As at the end of October 31, 2003, there were 31 funds, which manage assets of Rs.126726 crores under 386 schemes.
The graph indicates the growth of assets over the years.

GROWTH IN ASSETS UNDER MANAGEMENT



Note:

Erstwhile UTI was bifurcated into UTI Mutual Fund and the Specified Undertaking of the Unit Trust of India effective from February 2003. The Assets under management of the Specified Undertaking of the Unit Trust of India has therefore been excluded from the total assets of the industry as a whole from February 2003 onwards.

LESSON 28
DEVELOPMENT FINANCIAL INSTITUTIONS: AN INTRODUCTION

Lesson Objectives: **To understand the working of Development finance institutions, their role in industrial development, Governments policy for DFIs.**

INTRODUCTION

The economic development of any country depends on the extent to which its financial system efficiently and effectively mobilizes and allocates resources. There are a number of banks and financial institutions that perform this function; one of them is the development bank. Development banks are unique financial institutions that perform the special task of fostering the development of a nation, generally not undertaken by other banks.

Development banks are financial agencies that provide medium- and long-term financial assistance and act as catalytic agents in promoting balanced development of the country. They are engaged in promotion and development of industry, agriculture, and other key sectors. They also provide development services that can aid in the accelerated growth of an economy.

The objectives of development banks are:

(i) to serve as an agent of development in various sectors, viz. industry, agriculture, and international trade
(ii) to accelerate the growth of the economy
(iii) to allocate resources to high priority areas
(iv) to foster rapid industrialization, particularly in the private sector, so as to provide employment opportunities as well as higher production
(v) to develop entrepreneurial skills
(vi) to promote the development of rural areas
(vii) to finance housing, small scale industries, infrastructure, and social utilities

In addition, they are assigned a special role in:

(i) planning, promoting, and developing industries to fill the gaps in industrial sector
(ii) coordinating the working of institutions engaged in financing, promoting or developing industries, agriculture, or trade
(iii) rendering promotional services such as discovering project ideas, undertaking feasibility studies, and providing technical, financial, and managerial assistance for the implementation of projects

EVOLUTION OF DEVELOPMENTAL BANKS

The concept of development banking originated during the post Second World War period. Many countries of Europe were in the stage of industrial development and special financial institutions known as development banks were set up to foster industrial growth. In the US, development finance institutions came into existence for special purposes such as economic rehabilitation and filling gaps in the traditional financing pattern. Not only developed countries, but several underdeveloped countries in Asia, Africa, and Latin America established special financial institutions to hasten the pace of industrialisation and growth.

The International Bank for Reconstruction and Development (IBRD) known as the World Bank and the International Monetary Fund (IMF) are examples of development banks at the international level. The major objective of the World Bank is to promote world development and perform the task of transfer of enormous financial and technical resources from the developed to developing nations. The IMF performs a special function of providing financial assistance to private sector projects in developing countries.

Development Financial Institutions in India The need for development financial institutions was felt very strongly immediately after India attained independence. The country needed a strong capital goods sector to support and accelerate the pace of industrialisation. The existing industries required long-term funds for their reconstruction, modemisation, expansion and diversification programmes while the new industries required enormous investment for setting up gigantic projects in the capital goods sector. However, there were gaps in the banking system and capital markets which needed to be filled to meet this enormous requirement of funds.

(i) Commercial banks had traditionally confined themselves to financing working capital requirements of trade and industry and abstained from supplying long-term finance.

(ii) The managing agency houses, which had served as important adjuncts to the capital market, showed their apathy to investment in risky ventures.

(iii) Several malpractices, such as misuse of funds, excess speculation, and manipulations were unearthed. Owing to this, the investors were not interested in investing in the capital market.

(iv) There were a limited number of issue houses and underwriting firms that sponsored security issues.

Hence, to fill these gaps, a new institutional machinery was devised-the setting up of special financial institutions, which would provide the necessary financial resources and know-how so as to foster the industrial growth of the country.
The first step towards building up a structure of development financial institutions was taken in 1948 by establishing the Industrial Finance Corporation of India Limited (IFCI). This institution was set up by an Act I of Parliament with a view to providing medium- and long-term credit to units in the corporate sector and industrial concerns.

In view of the immensity of the task and vast size of the country, it was not possible for a single institution to cater to the financial needs of small industries spread in different states. Hence, the necessity for setting up I regional development banks to cater to the needs of small and medium enterprises was recognized. Accordingly, the

State Financial Corporations Act was passed in 1951 for setting up state financial corporations (SFCs)in different states. By 1955-56, 12 SFCs were set up and by 1967-68, all the 18 SFCs now in operation came I into existence. SFCs extend financial assistance to small enterprises.

Even as the SFCs were being set up, a new corporation was established in 1955 at the all-India level r known as the National Small Industries Corporation (NSIC) to extend support to small industries. The NSlC ; is a fully government owned corporation and is not primarily a financing institution. It helps small scale I industries (SSls) through various promotional activities, such as assistance in securing orders, marketing the products of SSls, arranging for the supply of machinery, and training of industrial workers.

The above institutions had kept themselves away from the underwriting and investment business as these were considered to be risky. Due to the absence of underwriting facilities, new entrepreneurs and small units could not raise equity capital nor could they get loan assistance owing to this weak financial position. To fill this gap, the Industrial Credit and Investment Corporation of India Limited (ICICI) was set up in January 1955 as a joint stock company with support from the Government of India, the World Bank, the Commonwealth Development Finance Corporation, and other foreign institutions. The ICICI was organised as a wholly privately owned institution; it started its operation as an issuing-cum-lending institution. It provides term loans and takes an active part in the underwriting of and direct investments in the shares of industrial units.

In 1958, another institution, known as the Refinance Corporation for Industry (RCI) was set up by the Reserve Bank of India (RBI), the Life Insurance Corporation of India (LIC), and commercial banks with a view to providing refinance to commercial banks and subsequently to SFCs against term loans granted by hem to industrial concerns in the private sector. When the Industrial Development Bank of India (IDBI) was Jet up in 1964 as the central coordinating agency in the field of industrial finance, the RCI was merged with it.

At the state level, another type of institution, namely, the State Industrial Development Corporation (SIDC) was established in the sixties to promote medium and large scale industrial units in the respective states. The SIDCs promoted a number of projects in the joint sector and assisted in setting up industrial units. In recognition of the crucial role played by them in the promotion of industries in different states, the SIDCs were made eligible for IDBI refinance facilities in 1976. Thus, they became an integral part of the development banking system of the country.

The State Small Industries Development Corporations (SSIDCs) were also established to cater to the requirements of the industry at the state level. They helped in setting up and managing industrial estates, supplying of raw materials, running common service facilities, and supplying machinery on hire-purchase basis.

By the early sixties, a plethora of financial corporations catering to the financial needs of a variety of industries had come into existence. However, the need for an effective

mechanism to coordinate and integrate the activities of the different financial institutions was increasingly felt. Furthermore, many gigantic projects of national importance were held up as these financial institutions were not able to supply the necessary capital in view of their own limited resources. Hence, the establishment of a financial institution with a substantially large amount of capital resource and capable of functioning independently, unhindered by statutory rigidities, became inevitable.

The Industrial Development Bank of India (IDBI) was set up in 1964 as an apex institution to establish an appropriate working relationship among financial institutions, coordinate their activities, and build a pattern of inter-institutional cooperation to effectively meet the changing needs of the industrial structure. IDBI was set up as a wholly owned subsidiary of the Reserve Bank of India. The IFCI became a subsidiary of the IDBI so that it might play an enlarged role. In February 1976, the IDBI was restructured and separated from the control of the RBI.

An important feature of industrial finance in the country is the participation of major investment institutions in consortium with other all India financial institutions. The Unit Trust of India (UTI), established in 1964, the Life Insurance Corporation of India (LIC), established in 1956, and the General Insurance Corporation of India (GIC), established in 1973, work closely with other all India financial institutions to meet the financial requirements of the industrial sector.

Specialized institutions were also created to cater to the needs of the rehabilitation of sick industrial units, export finance, and agriculture and rural development. In 1971, the Industrial Reconstruction Corporation of India Limited (IRCI) was' set up for the rehabilitation of sick units. In January 1982, the Export-Import Bank of India (EXIM Bank) was set up. The export finance operations of the IDBI were transferred to the EXIM Bank with effect from March 1, 1982. With a view to strengthening the institutional network catering to the credit needs of the agricultural and rural sectors, the National Bank for Agriculture and Rural Development (NABARD) was set up in July 1982.

The country is being served by 57 financial institutions, comprising 11 institutions at the national level and 46 institutions at the state level. These financial institutions have a wide network of branches and are supported by technical consultancy organisations with IDBI acting as the apex institution for coordinating their diverse financing and promotional activities. Their strategies, policies, and industrial promotional efforts subserve the national objectives of rapid industrial growth, balanced regional development, creation of a new class of entrepreneurs, and providing self employment opportunities.

The national level institutions, known as All India Financial Institutions (AIFIs), comprise six All India Development Banks (AIDBs), two specialised financial institutions (SFIs) and three investment institutions. The AIDBs are IDBI, IFCI, ICICI, Industrial Investment Bank of India Limited (IIBI), Infrastructure Development Finance Company Limited (IDFC) and SIDBI.

At the state level; there are 18 State Financial Corporations (SFCs) and 28 State Industrial Development Corporations (SIDCs).

The Specialised Financial Institutions (SFIs) comprise Export-Import Bank of India (EXIM Bank) and National Bank for Agriculture and Rural Development (NABARD). Hitherto, SFIs included three institutions, namely, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Company Limited, and Tourism Finance Corporation of India Limited. However, due to the tiny nature of their operations, these institutions have been excluded from the category of SFIs.
The investment institutions are Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), and Unit Trust of India (UTI).

CHANGING ROLE OF DEVELOPMENT FINANCIAL INSTITUTIONS

The financial institutions were functioning in a highly regulated regime up to 1991. The DFIs were mostly engaged in consortium lending and they offered similar services at uniform prices. In the administered interest rate regime, the cost of borrowings of DFIs was substantially lower than the return on financing (lending). Long-term lending involves uncertainties and to handle this, the DFIs used to get concessional funds up to the nineties. The Reserve Bank and the Central Government used to finance these institutions by subscribing to the share capital, allowing them to issue government guaranteed bonds and extending long-term loans at concessional rates. However, this concession all ending was phased out in the 'nineties' with the initiation of financial sector reforms. Interest rates were deregulated and the facility of issuing bonds eligible for SLR investments was withdrawn. Now, these financial institutions have to rely on equity and debt markets for financing their needs. These DFIs have resorted to market-based financing by floating a number of innovative 1ebt and equity issues. They also raise resources by way of term deposits, certificates of deposits and borrowings from the term money market within the umbrella limit fixed by the Reserve Bank in terms of net owned funds. Wore stringent provisioning norms have come into operation. Many of the DFIs including IDBI have lost heir tax-exempt status.

Moreover, with deregulation, the distinction between different segments of financial intermediaries has blurred. The commercial banks are now financing the medium- and long-term capital needs of the corporate sector and the DFIs have started extending short-term/working capital finance. This has led to a stiff competition)between banks and DFIs. As a result, the focus of DFIs has shifted from the purpose for which they were set up.

With globalisation and liberalisation, the financing requirements of the corporate sector has undergone a tremendous change. Many foreign players entered into strategic alliances with Indian firms. There was an increase in research and development activities as well as the diversification plans of firms. Investment in technology and infrastructure became crucial. With a view to taking advantage of the new opportunities, the financial institutions started offering a wide range of new products and services. These DFIs set up several subsidiaries/associate institutions which offer various services such as commercial banking. consumer finance, investor

and custodial services, broking, venture capital finance. Infrastructure financing, registrar and transfer services, and e-commerce.

DFIs are in the process of converting themselves into universal banks. ICICI has become a universal bank by a reverse merger with its subsidiary ICICI Bank. IDBI is in the process of transforming itself into a universal bank. The Reserve Bank of India has issued guidelines for DFIs to become commercial Banks. These guidelines are the same as for commercial banks under the Banking Regulation Act. It is envisaged that will be only two types of financial intermediaries in future, that is, commercial banks and non-banking ace companies (NBFCs).

UNIVERSAL BANKING

Universal banking is a one-stop shop of financial products and services. Universal banks provide a complete range of corporate financial solutions under one roof -- everything from term finance, working capital, project advisory services, and treasury consultancy. Universal banking encompasses commercial banking and Investment banking, including investment in equities and project finance. It refers to a bank undertaking all types of business-retail, wholesale, merchant, private, and others under one organisational roof. It means a complete breakdown of barriers between different categories of financial intermediaries such as commercial banks, FIs and NBFCs.

Universal banking helps the service provider to build up long-term relationships with the client by catering his different needs. The client also benefits as he gets a whole range of services at low cost under one roof. Globally, banks such as Deutsche Bank, Citibank, and ING Bank, are universal banks.
In India, the trend towards universal banking began when financial institutions were allowed to finance working capital requirements and banks started term financing.

This trend got a momentum with the report of Narasimham Committee II, suggesting that development finance institutions should convert ultimately into commercial banks or non-bank finance companies (NBFCs). The Khan Committee, which was set up by RBI to examine the harmonisation of business of banks and development financial institutions, endorsed this conversion. It was of the view that DFIs should be allowed to become banks at the earliest. The committee recommended a gradual move towards universal banking and an enabling framework for this purpose should be evolved. In January 1999, the Reserve Bank of India (RBI) released a "Discussion Paper" for wider public debate on universal banking. The feedback indicated the desirability of universal banking from the point of view of efficiency of resource use. In the mid-term review of monetary and credit policy (1999-2000), the RBI acknowledged that the principle of universal banking "is a desirable goal". In April 2001 it set out the operational and regulatory aspects of conversion of DFIs into universal banks.

ICICI was the first financial institution to convert itself into a truly universal bank. The concept of universal banking provides the financial institutions an access to the retail market wherein high margins are involved. This concept is slowly gaining

popularity among banks as the interest spread has squeezed in the past few years and non-performing assets (NPAs) have increased in banking activity. A foray into universal banking would help the banks to diversify beyond the traditional portfolio of loans and investment and extend to treasury, capital market operations, infrastructure finance, retail lending, and advisory services.

POLICY MEASURES RELATING TO DFIs

The change in the role of DFIs, the South-East Asian crisis and the general economic slowdown necessitated introduction of policy measures and regulation. In November 1994, the Board for Financial Supervision (BFS) was constituted under the aegis of the Reserve Bank for comprehensive and integrated regulation and supervision over commercial banks. Financial Institutions (FIs) and Non-Banking Finance companies have been brought under the purview of the Board. The scope and coverage of the FIs inspection are very limited, unlike that of NBFCs, and are not as rigorous as that of banks.

Select FIs such as IDBI, ICICI Ltd., IFCI Ltd., IIBI Ltd., NABARD, NHB, EXIM Bank, TFCI, SIDBI and IDFC have been brought under the supervisory purview of the Reserve Bank to enhance the transparency in their performance and maintain systemic stability.

Policy Measures

(i) Financial institutions were permitted to include the "general provision on standard assets" in their supplementary (tier II) capital with a stipulation that the provisions on standard assets along with other "general provisions and loss reserves" should not exceed 1.25% of the total risk-weighted assets.

(ii) An asset would be treated as non-performing, if interest and/or installment of principal remain overdue for more than 180 days with effect from the year ending March 31, 2002. A non-performing asset is that part of a financial institution's asset that is currently yielding no return and on which none is expected.

(iii) FIs have to assign a 100 percent risk weight only on those state government guaranteed securities which were issued by the defaulting entities.

(iv) FIs are required to assign a risk weight of 2.5% for market risk in respect of investments in all securities from March 31,2001. This risk weight would be in addition to 20%/100% risk weight already assigned for credit risk in non-government/non-approved securities.

(v) In order to bring about uniformity in the disclosure practices adopted by the FIs and with a view to improving the transparency in their affairs, FIs were advised to disclose certain important financial ratios/data with effect from the financial year 2000-01. These disclosures pertain to capital-to-risk weighted assets ratio (CRAR), Core CRAR, supplementary CRAR, amount of subordinated debt raised/ outstanding as tier II capital, risk weighted assets, shareholding pattern, asset quality and credit concentration, maturity pattern of rupee and foreign currency assets and liabilities, and details on operating results. Besides, separate details on loan assets arid substandard assets which have been subject to restructuring, and so on, would also need to be disclosed.

(vi) Capital to risk-weighted Asset Ratio (CRAR) should be 9% of risk weighted assets (RWA) on an ongoing basis. CRAR represents the amount of capital maintained in consonance with the risk-adjusted aggregate of funded and non-funded assets of an FI. The risk-adjusted asset is arrived at by multiplying each asset with its corresponding risk weight in the case of funded assets. Conversion factors are assigned in case of non-funded assets apart from weights. CRAR includes core capital (tier I) and supplementary capital (tier II). Tier I capital includes paid up capital, statutory reserves, and other disclosed free reserves, if any. Certain Government of India grants and reserves held under section 36(1)(viii) of the Income Tax Act, 1961 are treated as capital. Besides capital reserves, equity investment in subsidiaries, intangible assets, gaps in provisioning, and losses in the current period and those brought forward from the previous period will be deducted from tier I capital. The core CRAR should not be less than 50% of CRAR at any point of time. Supplementary CRAR, or tier II capital, includes undisclosed reserves and cumulative preference shares, revaluation reserves, general provisions and reserves, hybrid debt capital instruments, and subordinated debt. The supplementary capital is limited to a maximum of 100% of tier I capital.

(vii) Since June 2000, FIs need not seek the Reserve Bank's issue-wise prior approval/registration for raising resources through either public issue or private placement if (a) the minimum maturity period is 3 years, (b) where bonds have call/put or both options, the same is not exercisable before expiry of one year from date of issue, (c) yield to maturity (YTM) offered at the time of issue of bonds, including instruments having call/put options, does not exceed 200 basis points over that on government securities of equal residual maturities, and (d) 'exit' option is not offered prior to expiry of one year, from date of issue. The outstanding total resources mobilised at any point of time by an individual FI including funds mobilised under the 'umbrella limit' as prescribed by the Reserve Bank should not exceed 10 times its net owned funds as per the latest audited balance sheet.

(viii) The rating for the term deposits accepted by FIs was made mandatory effective November 1,2000.

(ix) FIs are required to classify entire investment portfolio from March 31, 2001, under three categories, viz., (a) held to maturity, (b) available for sale, and (c) held for trading. Investments under (b) and (c) are to be marked-to-market as prescribed or at more frequent intervals, while those under (a) need not be marked-to-market and should not exceed 25% of total investments.

(x) Looking to the deteriorating financial position of FIs, it was decided that the inspection of all the FII would be undertaken by the Reserve Bank on an annual basis with effect from March 31,2001.

(xi) The Reserve Bank introduced a CAMELS based supervisory rating model for the FIs effective March 31,2002.

The above mentioned policy initiatives were undertaken by the RBI for strengthening the regulation and supervision of select all India financial institutions in the context of

their financial performance, the market conditions for resource mobilisation and increasing competition from banks.
Now we will look into the working of few major DFIs.

LESSON 29

DEVELOPMENT FINANCIAL INSTITUTIONS: MAJOR PLAYERS

Lesson Objectives: **To know in short about specific DFIs and their working.**
Role of major DFIs in Industrial Growth

Dear friends, in the last session we took a look into the evolution of DFIs in India and about their importance in development activity. Now in today's and next session we are going to discuss about the specific major DFIs in India.

INDUSTRIAL FINANCE CORPORATION OF INDIA LIMITED

Industrial Finance Corporation of India Limited (IFCI), India's first DFI, was established on July 1, 1948, under the Industrial Finance Corporation Act as a statutory corporation. It was set up to provide institutional credit to medium and large industries.

With a view to imparting greater operational flexibility and enhancing its ability to respond to the needs of the changing financial system, IFCI was converted from a statutory corporation to a public limited company. It was the first institution in the financial sector to be converted into a public limited company on July 1, 1993. IFCI is a board-run company and its directors are elected by shareholders.

IFCI's principal activities can be categorised into financing and promotional activities.

Financing Activities

IFCI's financing operations include project financing, financial service and corporate advisory services.

(i) *Project financing*: Project financing is the core business of IFCI. The main' objective behind the incorporation of the DFI was to fund green-field projects. Financial assistance is provided by way of mediumllong-term credit for setting up new projects, expansion/diversification schemes, modernisationl balancing schemes of existing projects.
Financial assistance is provided by way of rupee loans, loans in foreign currencies, underwriting ofl direct subscription to shares and debentures, providing guarantee for deferred payments and loans.

(ii) *Financial services*: IFCI provides tailor-made assistance to meet specific needs of corporate through specifically designed schemes. The various fund-based products offered are equipment finance, equipment credit, equipment leasing, supplier's/buyer's credit, leasing and hire purchase concerns, working capital term loans, short-term loans, equipment procurement, installment credit, and others. The fee-based services offered by it are guarantees and letters of credit.

(iii) *Corporate advisory services*: IFCI provides advisory services in the areas of projects, infrastructure, corporate finance, investment banking, and corporate restructuring. It also acts as a catalyst in channelising foreign direct investments (FDIs) and provides a range of services to prospective foreign investors. FCI also provides consultancy services on certain policy-related technical and financial matters to regulatory agencies in different infrastructure sectors, namely, electricity, telecom, oil and gas, insurance, education, and so on.

(iv) *Corporate advisory services to foreign investors*: IFCI provides a whole range of services to prospective foreign investors, namely, facilitating the foreign business entities through information services; necessary office infrastructure for the start-up operations of the organisation; coordination for obtaining the required approvals/clearances from the government departments/ regulators/statutory agencies; inputs on markets, materials, and manpower available in the country; inputs on available manufacturing facilities; syndication services for obtaining the required capital; research inputs and information regarding tax incentives; tariff protections, and opportunities available for acquisitions, mergers, and amalgamations.

Promotional Activities

Over the years, IFCI has set up several subsidiaries/associate companies in the financial sector offering custodial services, investor services, rating services, and venture capital services.

Shareholding Pattern of IFCI's Equity Share Capital

Public	25.82%
Government owned and controlled banks/organizations	56.32%
Other corporate bodies	6.98%
MFs/UTI	4.73%
Other banks	6.15%

Financial Highlights of IFCI Profit after Tax

Year ending	Profit after tax (Rs in crore)
March 1997	218.56
March 1998	83.50
March 1999	(-267.70)
March 2000	(-191.81)
March 2001	(-265.93)
March 2002	(-884.7)
Quarter ending June 2002	(-221.56)

Source: IFCI.

Financial Ratios of IFCI

Particulars	Year ending				
	March 1997	March 1998	March 1999	March 2000	March 2001
PAT/Networth	14.50	5.37	-16.95	-11.58	17.49
PAT/ Total assets	1.44	0.44	-1.24	-0.85	-1.19

PBDT/ Total asets	2.24	1.05	-01.04	-0.62	-0.98
PBDT/Capital employed	2.49	1.13	-1.12	-0.67	-1.05
EPS (Rs)	10.7	10.3	-0.1	0.1	-4.2
Debt Equity Ratio	9.4	11.6	12.6	12.2	15.6
Capital adequacy ratio	10.1	11.6	8.4	8.8	6.2

Source: IDBI, Report on Development Banking in India, 2000-01.

Asset Classification of IFCI
(In percentage)

	2000	2001	2002
Standard assets	80.7	80.9	77.5
Sub-standard assets	11.1	5.0	5.1
Doubtful assets	8.2	14.1	17.4
Total	100.0	100.0	100.0

Source: IDBI, Report on Development Banking in India, 2000-01.

Since 1998-99, the assistance sanctioned and disbursed by IFCI has declined. During 2000--01, sanction! and disbursements under direct finance constituting 99.4% and 99.5% of overall sanctions an(disbursement declined by 10.8% and 35.3%, respectively. Sanctions and disbursements under project finance accounting for 97.5% and 94.7% of the total sanctions and disbursement! declined by 8.3% and 30%, respectively in 2000-01. The decline was recorded across all the products under project finance.

IFCI started reporting losses from 1999. In 1999, it reported a loss of Rs 267.70 crore which increased to Rs 884.7 crore in 2001-02. Spreads (the difference between interest income and expense) have begun to narrow across the financial sector due to stiff competition. This has had an impact on the profitability of FCI The non-performing assets (NPAs) of the company at Rs 3,937.2 crore have touched 46% of its total assets of Rs 8,183.2 crore. Its capital adequacy ratio is just 3%, way below the stipulated 12% In the first quarter of April-June 2002, IFCI reported a loss of Rs 221 crore as against a loss of Rs 27.8 crore in the same period of the previous year. Interest expenses for the quarter moved up drastically to Rs 606.: crore, as against Rs 163 crore in the same period of the previous year, while interest income dwindled by 30% to Rs 445.3 crore.

IFCI's financial health has deteriorated and the present state of affairs displays a dismal picture of the company. The reasons attributable to this dismal state of affairs of the company are:

(i) *Operational inefficiency* : The cost of borrowing has exceeded the income from operations.
(ii) *Political interference* : IFCI has been used as a handmaiden of politicians and most of the loans have been sanctioned under political pressures.
(iii) *Traditional sector financing* : IFCI has sanctioned majority of the loans in traditional sectors such as iron and steel, textiles, synthetic fibres, cement,

synthetic resins, plastics, and so on. These traditional sectors are facing rough times due to demand recession, price fluctuations, abolition of import controls, gradual reduction of tariffs, among others. Hence, this has led to a rise in NPAs of IFCI.

(iv) *Higher provisioning for non-performing assets* : Project financing is the major activity of IFCI and revenue arising from this activity constitutes a substantial portion of its revenues. These projects have. a long gestation period. RBI has tightened the provisioning norms for NPAs and stipulated that loans related to projects under implementation have to be classified as NPA. Hence, the company has to make larger provision at the end of the year, dampening the net profit level.

These huge NPAs have made IFCI terminally ill. IFCI has raised Rs 1237 crore through public issue and Rs 13,689 crore in private placements for lending operations. This amount has to be paid back to public. sector banks, mutual funds, trusts, and provident funds that invested in these tax-free instruments. IFCI has: Rs 900 crore redemption obligation on bonds, guarantee commitments of Rs 800 crore, foreign currency loan of $100mn and rupee loans of Rs 300 crore. Any default can cause systemic risks and could weaken confidence in the system. IFCI's rating has plummeted to default category, which means it cannot raise fun to lend profitably..

GOI, based on the recommendations of Basu Committee appointed for suggesting a restructuring plan for IFCI, declared a Rs 1,000 crore package for IFCI in late 2001. This package consisted of two parts: Rs 400 crore were given by the Government by way of subscription to long-term convertible debentures and the remaining Rs 600 crore were contributed by the government controlled institutional shareholders of IFCI on pro-rata basis. IDBI is the principal shareholder of IFCI with 31.71% shareholding and it had to make the largest contribution among the FIs. But IDBI itself is in trouble and the government is drawing out a bailout package for it also. In this situation, the SBI lent a helping hand by contributing towards IDBI's share. But this package also could not save IFCI from the burgeoning NPAs and declining capital adequacy ratio.

Steps Taken for Revival

IFCI constituted an expert committee in 2001 to formulate a medium- to long-term strategic plan for IFCI in the emerging new business environment. The committee has laid down the road map/action plan for the next five years. The committee has made recommendations covering a wide range of structural and operational areas.

IFCI is concentrating on its core competence and is focusing on lending to established clients with a sound track record. It has strengthened its risk management techniques and is putting in efforts to bring down the NPAs to a manageable level, through corporate debt structuring.

The company has initiated the process of restructuring of liabilities and is negotiating with the investors for reduction of interest rate on deposits and bonds. IFCI has initiated action against defaulters and has filed suits against. defaulter companies.

In spite of all these efforts, the financial state of affairs of the company has not improved.

The Government's Bailout Plans

The government appointed the international consulting giant McKinsey to suggest the amount of funds needed to revive IFCI and a course of action to get the company back into profit zone.

McKinsey suggested that IFCI should be divided into two companies: one with good assets and the other with bad assets. The company with good assets would provide financing to mid-sized companies and undertake fee-based services. The business model for the good bank entails merger with a potential universal bank. An asset reconstruction company should be set up with a capital of Rs 200 crore to take care of the bad loans worth Rs 4,000 crore. The bailing out would cost the government around Rs 5.26 billion to Rs 88 billion and the cost of liquidation would be between Rs 88-122 billion. The one-time cost to the government for bailing out the institution is pegged at Rs 11,200 crore.

The government's bailout package includes a Rs 8,100 crore infusion of funds, converting the financial institution into an asset reconstruction company (ARC) without engaging in any borrowing or lending, and changes in the top management of the organisation. The Rs 8,100 crore package will be utilised to redeem the bonds issued to government provident funds, nationalised banks and pension funds.

Conclusion

The oldest development financial institution is facing rough weather and the future looks grim. IFCI is the worst hit by the NPA problem. It is in the process of restructuring its liabilities and has set up an asset reconstruction company, namely, Assets Care Enterprises Limited (ACE) with an initial authorised capital of Rs 20.00 crore. ACE has prepared an initial business plan and it envisages a gradual build-up of business to maximise recovery in non-performing assets.

Now let us look into the another major DFI and
its working.

INDUSTRIAL DEVELOPMENT BANK OF INDIA

The Industrial Development Bank of India (IDBI) was established in 1964 by Parliament as a wholly owned subsidiary of Reserve Bank of India. In 1976, the Bank's ownership was transferred to the Government of India. It was accorded the status of the Principal Financial Institution for coordinating the working of institutions at national and state levels engaged in financing, promoting, and developing industries.

IDBI has provided assistance to development-related projects and contributed to building up substantial ~opacities in all major industries in India. IDBI has directly or indirectly assisted all companies that are Presently reckoned as major corporate in the country. It has played a dominant role in balanced industrial development.

In 1982, IDBI transferred its International Finance Division to Export-Import Bank of India, which was established as a wholly owned corporation of Government of India under Export Import Bank of India Act, 1982.

IDBI set up the Small Industries Development Bank of India (SIDBI) as a wholly owned subsidiary to cater to specific the needs of the small-scale sector. In 2001, IDBI reduced its shareholding in SIDBI to 49%. .
IDBI has engineered the development of capital market through helping in setting up of the Securities exchange Board of India (SEBI), National Stock Exchange of India Limited (NSE), Credit Analysis and research Limited (CARE), Stock Holding Corporation of India Limited (SHCIL), Investor Services of India limited (ISIL), National Securities Depository Limited (NSDL), and Clearing Corporation of India Limited CCIL).
In 1992, IDBI accessed the domestic retail debt market for the first time by issuing innovative bonds known as the Deep Discount Bonds. These new bonds became highly popular with the Indian investor.

In 1994, the IDBI Act was amended to permit public ownership upto 49%. In July 1995, it raised over Rs 20 billion in its first Initial Public Offer (IPO) of equity, thereby reducing the government stake to '2.14%. In June 2000, a part of government shareholding was converted to preference capital. This capital was redeemed in March 2001, which led to a reduction in government stake. The government stake currently is 58.47%.
In August 2000, IDBI became the first All India Financial Institution to obtain ISO 9002: 1994 Certification for its treasury operations. It also became the first organisation in the Indian financial sector to obtain ISO 001: 2000 Certification for its forex services.
In March 2001, IDBI set up the IDBI Trusteeship Services Limited under the Companies Act, 1956, to provide technology driven information and professional services to subscribers and issuers of debentures.

IDBI has undertaken several initiatives to reposition itself as a universal bank. In April 2001, IDBI appointed Boston Consulting Group India Private Limited (BCG) as consultant to draw up a road map for conversion into a universal bank. The other initiatives include formation of a high level Risk Management committee to develop overall risk management policy. The bank has constituted a Credit Risk Management group to evaluate credit risk both at the transaction level as also at the portfolio level.
In March 2002, the tovernment of India announced proximate corporatisation of IDBI.
Subsidiaries

(i) In 1993, IDBI set up IDBI Capital Market Services Limited (ICMS) as wholly owned stock broking company. It commenced operations as a primary dealer in November 1999. In the private placement market, it acts as an arranger for several institutions and corporate users. As a depository participant, the company offers institutional and retail clients the facility to maintain their investments and securities in electronic form.

(ii) In 1994, IDB! set up the IDBI Bank Limited, a private sector commercial bank. IDBI's shareholding in this bank is 57.14%. The Bank provides a complete range of banking facilities supported by a technology intensive environment. It is a leading player in depository participation services.

(iii) In 1999, IDBI set up the IDBI Investment Management Company Limited as a wholly owned subsidiary. It entered into a joint venture agreement with

Principal Financial Group, USA, for participation in equity and management of this subsidiary.

(iv) In March 2000, IDBI set up the IDBI Intech Limited as a wholly owned subsidiary to undertake captive IT-related activities.

(v) In March 2001, IDBI set up the IDBI Trusteeship Services Limited under Companies Act, 1956, to provide technology driven information and professional services to subscribers and issuers of debentures.

Shareholding Pattern of IDBI's Equity Share Capital

Individuals	16.72%
Corporate Bodies	4.75%
Others	0.14%
Banks and PIs	19.92%
Government	58.47%
	100.00%

Products and Services

Over the years, IDBI has enlarged its basket of products and services to industrial concerns. IDBI provides financial assistance both in rupee and foreign currency for greenfield projects, expansion, modernisation, and diversification.

In order to cater to the diverse needs of corporate clients, IDBI has structured various products such as equipment finance, asset credit, corporate loans, direct discounting, and working capital loans to finance acquisition of equipments and capital assets and to meet capital expenditure and/or incremental long-term working capital requirements. It also offers structured products such as lines of credit to meet the funding requirements for execution of turnkey contracts.

IDBI also provides indirect financial assistance through refinancing of loans extended by primary financial institutions and by way of rediscounting bills of exchange arising out of sale of indigenous machinery on deferred payment terms.

In 2001, IDBI launched an equity support scheme to facilitate early financial support to deserving assisted projects which are unable to tap the capital market. IDBI also introduced a new scheme for financing the film industry pursuant to the industry status being given to the entertainment industry.

IDBI also provides merchant banking and a wide array of corporate advisory services as part of its fee based activities. These include professional advice and services for issue management, private placement of equity/debt instruments, project evaluation, credit syndication, share valuation, corporate restructuring including mergers and acquisitions, and divestment of equity. The Bank also offers a number of forex-related services on a commission basis, including opening of letters of credit and remittances of foreign currency on behalf of its assisted companies for import of its goods and services.

Operational Highlights of IDBI

(Rs in crore)

FY ended March 31	1998	1999	2000	2001	2002
Sanctions	20,632	20,842	23,712	25,418	16,034
Disbursements	15,369	14,473	17,063	17,474	11 ,158
Profit before tax	1,800	1,301	1,027	734	415

Net profit after tax	1,501	1,259	947	691	424
Dividend	303	303	303	294	98
Dividend in percentage	(45)	(45)	(45)	(45)	(15)

Source: IDBI.

Financial Highlights of IDBI
(Rs in crores)

As on March 31	1998	1999	2000	2001	2002
Capital	659	659	659	653	653
Reserves	7,344	8,034	8,366	8,474	6,001
Net owned funds	8,003	8,693	9,025	9,127	6,654
Tier I capital bonds	-	-	-	-	2,130
Borrowings	45,520	52,968	57,178	56,419	51,752
Assets	59,957	69,144	72,285	71,783	66,643
Net NPA (% of total assets)	10.1	12.0	13.4	14.8	11.7
Capital adequacy ratio	13.7	12.7	14.5	15.8	17.9
Debt equity ratio	6.1	6.5	6.8	6.7	6.3
EPS (Rs)	22.3	18.70	10.32	9.37	6.50

Source: IDBI.

The table reveals a sharp decline in sanctions and disbursement in the year 2001-02. Sanctions t, infrastructure sector which were Rs 3,145 crore in 2001-02, constituted 20% of overall sanctions. Th profit before tax and profit after tax have consistently declined since 1997-98.

Trends in Returns and Cost of IDBI
(In percentage)

	1997-98	1998-99	1999-2000	2000-01	2001-02
Average return	12.6	11.6	11.1	10.4	10.4
Average cost	8.7	9.0	9.2	9.0	9.2
Margin	3.9	2.6	1.9	1.4	1.2

The table reflects a declining trend in margins. There has been a pressure on margins due to declining interest rates and increasing competition. The other factors responsible for a decline in profits are industrial slowdown, lack of good proposals, disinter mediation and exit of good clients, and the changing business environment. Out of its total assets of Rs 66,643 crore assets, 11.7% are non-performing. IDBI has classified Rs 4,350.70 crore as NPA for the year 2002.

Asset Quality of IDBI

	2000-01	2001-02
Standard	85%	88%
Doubtful	10%	7%
Substandard	5%	5%

Source: 1081.

During 2001-02 an accelerated provisioning of Rs 2,500 crore brought down the level of NPAs to 11.7% in 2001-02 from 14.8% in 2000-01. The steel sector accounts for the highest NPA of IDBI. IDBI has NPA of Rs 838.50 crore in iron and steel sector contributing 15.5% of the total NPA for the year March 31, 2002. The steel sector was followed by the textile sector, which accounted for 13.70 percent of the total NPA. The other major sectors are food processing, metal and metal products, and drugs and pharmaceuticals. This exposure to the problematic commodity sector makes a turn around unlikely.

IDBI is rated AA lower than the AAA rating of the corporate it wishes to lend to. Hence, it cannot raise funds to lend profitably. IDBI is under severe stress with so high NPAs.
IDBI has raised Rs 13,012 crore in public issues and has privately placed debt worth Rs 16,788 crore. This amount has to be paid back to investors such as public sector banks, mutual funds, trusts, and provident funds. Any default would again pose a systemic risk.

The Government's Bailout Plans

The government is keen on structurally transforming IDBI. The structural reforms options being considered include granting IDBI a banking license and enabling it to enter into an alliance with either a public or private sector bank or roping in a strategic partner. The government has repealed the IDBI Act, 1964, thus providing for the corporation of the Industrial Development Bank of India. While retaining its character as a development financial institution, a new legislation would turn it into a banking company, thus facilitating availability of finance at concessional rates. The government is not providing it with a money package but it would stand surety of upto Rs 2,500 crore over a period of five years.

Conclusion :
IDBI's objective is to position itself as India's premier wholesale bank, providing a full range of wholesale products through an integrated group structure. For accomplishing this, it has laid down its short-term and long-term strategies.
The short-term strategy would revolve around business growth of acceptable quality, reduction in costs, and improved risk management practices. Hence, the bank's priorities would be NPA containment and diminution along with recovery maximisation, reducing the average cost of funds, fresh borrowings at optimum combination of cost and maturity, retail funding through its fixed deposit scheme to ensure access to stable source of funds and broad-basing the ambit of its fee-based activities. IDBI is placing more emphasis on non-project loans.

As part of its long-term strategy, IDBI has chosen universal banking as its basic business model. IDBI is currently undertaking calibrated measures to move towards universal banking.

INDUSTRIAL INVESTMENT BANK OF INDIA LIMITED

Industrial Investment Bank of India Ltd. (IIBI) was set up as a company, under the Companies Act, 1956, in March 1997 by converting the erstwhile Industrial Reconstruction Bank of India. The Industrial Reconstruction Bank of India (IRBI) was set up in 1985 under the IRBI Act, 1984, as the principal credit and reconstruction agency for rehabilitation of sick and closed industrial units. With a view to providing IRBI with adequate operational flexibility and financial autonomy and converting it into a full-fledged all-purpose financial institution, IRBI was incorporated as IIBI, with headquarters in Calcutta.

As per the Memorandum and Articles of Association, IIBI can

(a) provide financial assistance, with or without security, in the form of short, medium, long-term loan, demand loan, working capital facilities, equity participation, asset credit, and equipment finance.
(b) invest in capital market instruments such as shares, debentures, bonds, and also money market instruments.
(c) underwrite and extend guarantees.
(d) engage in leasing and hire purchase finance.
(e) act as a Trustee of any deed securing any investment.
(f) provide consultancy and merchant banking, warehousing, factoring, depository, and custodial services.
(g) set up subsidiaries in the form of an investment company to deal in capital and money market instruments.
(h) operate as an authorised dealer in foreign exchange.

IIBI is the only all-India financial institution (API) wholly owned by the Government of India. IIBI is exempted from payment of income tax for the first five years of its operations as per the Industrial Reconstruction Bank (Transfer of Undertaking and Repeal) Act, 1997. It is now an API with a well diversified portfolio spread over a wide range of industrial segments.
Services Provided by IIBI

IIBI provides project finance, short duration non-project asset-backed finance and working capital/short term loans to companies. Since 2000-01, IIBI has diversified into investment in rated debentures bonds of corporate and sovereign state government guaranteed debt papers. These accounted for 58.4% of its investment asset portfolio as on March 31,2001. Due to its diversification into investments, the percentage share of loans in the outstanding portfolio declined from 82% as on March 31, 2000, to 66.4% on March 31, 2001.

Besides these, it provides various services as deferred payment guarantee, loan syndication, merchant banking services such as issue management, underwriting and guarantees, project/reconstruction one-time settlement consultancy/ appraisal.

IIBI's Business Strategy

IIBI's business strategy aims at improving asset quality and generating profits. To attain these objectives, IIBI has placed emphasis on modem risk assessment and monitoring systems and organisation restructuring.

IIBI-Assistance Sanctioned and Disbursed Schemewise

(Rs in crore)

Particulars	*" Sanctions*						*Disbursements*				
	1996-97	1997-98	1998-99	*1999-2000*	*2000-01*	*Cumulative upto end March 2001*	1996-97	1997-98	1998-99	*1999-2000*	
Direct Finance A. Project Finance	665.36	884.79	1,172.56	1,057.27	902.00	5,369.03	418.17	424.41	806.25	570.4	
B. Non-Project Finance	150.65	1,176.25	841.65	1,207.90	637.00	3,400.06	131.43	728.77	721.28	796.2	
Tota1	816.01	2,061.04	2,014.21	2,265.17	1,539.00	8,769.09	549.60	1,153.18	1,527.53	1,366.67	1,192.
Loans and Investments in shares/bonds of Fls	-	-	160.95	72.91	121.72	380.82	-	-	160.95	72.91	
Secondary market operations	-	-	-	-	441.54	441 .54	-	-	-	-	
Grand total	816.01	2,061.04	2,175.16	2,338.08	2,102.26	9,591.51	549.60	1,153.18	1,688.48	1,439.	

Source: IDBI, *Report on Developml3nt Banking in India, 2000-01.*

Financial Highlights of IIBI

(Rs in crore)

	1999-2000	2000-2001
Gross income	520.16	587.00
Surplus before provision	96.24	139.61
Capital adequacy	9.70	13.28*
Earnings per share (Rs)	0.27	9.57
Book Value per Share (Rs)	31.32	28.55
NPA (%)	17.03	22.9
Profit after tax to average networth (%)	4.6	16.3
Profit after tax to average assets (%)	0.8	2.8
Debt equity ratio	5.3	4.7

* This has been obtained after setting aside, Rs 245 million as asset value fluctuation reserve. Source: IDBI, Report on Developing Banking in India, 2000-01.

IIBI'S Net NPA as% of Net Loans
(In percentage)

	1999-2000	2000-01	2001-02
Net NPA/Net Loans	17.0	22.9	24.1

Source: RBI, Report on Trend and Progress of Banking in India, 2001-02.

The above table reflects a decline in sanctions but an increase in disbursements in 2000-01. An increase of 18.8 percent in IIBI's disbursement during 2000-01 was mainly due to 31.3 percent growth in disbursements under project finance. This growth was supported by 87.3% rise in disbursements under underwriting and direct subscription. Disbursements were higher in case of infrastructure, transport equipment, and chemicals and chemical product industries. Both the private sector and the joint sector accounted. for a larger share in disbursements. During 2000-01, 63.5% of total sanctions Were granted for modernisation/ balancing equipment and 36.5% of the total sanctions were granted to companies facing cash crunch. There was a record increase of 66.9% in loans and investment in shares / bonds of FIs.

IIBI's total income increased by -12.9% in 2000-01 due to increase in income from lending, investments/deposits, and other income resulting from profit on sale of fixed assets and lower provisions due to recovery of NPAs. As IIBI is exempted from payment of income tax for the first five years of its operations, a net profit of Rs 110 crore implied a return on average net worth of 16.3% in 2000-01.
As-on March 31, 2001, IIBI's net NPAs constituted 22.9% of its net loan and investment portfolio. These NPAs increased further to 24.1% in 2001-02. IIBI ranks the first in the problem of non-performing assets among all-India financial institutions.

Conclusion
IIBI has a track record of profitability growth in operating income and dividend payment since its inception in 1997. IIBI aims to build business around a niche network of clients and investors, intermediating as intellectual resource and information centre and spearhead new ways of doing business. Hence, it is continuously upgrading the process, systems, and structures to build capabilities of integrated management, risk assessment, and risk control.

SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA

The Small Industries Development Bank of India (SIDBI) was set up in 1990 under an Act of Parliament the SIDBI Act, 1989. The Charter establishing SIDBI envisaged SIDBI to be "the principal financial institution for the promotion, financing and development of industries in the small scale sector and to coordinate the functions of other institutions engaged in similar activities."

SIDBI commenced its operations on April 2, 1990, by taking over the outstanding portfolio and activities of IDBI pertaining to the small scale sector. In pursuance of the SIDBI (Amendment) Act, 2000, and as approved by the Government of India,

51.1 % equity shares of SIDBI held by IDBI have been transferred to public sector banks, LIC, GIC, and other institutions owned and controlled by the central government. Presently SIDBI has 35 banks, insurance companies, investment and financial institutions as its shareholders in addition to IDBI, which continues to hold 49 % share in SIDBI.

Four basic objectives are set out in the SIDBI Charter. They are:

(a) Financing
(b) Promotion
(c) Development
(d) Coordination for orderly growth of the small scale industrial sector

SSI are the industrial units in which the investment in plant and machinery does not exceed Rs 10 million. The SSI sector, consisting of 3.1 million units, forms the backbone of the Indian economy, contributing to around 40% of India's total manufacturing sector output, around 35% of total exports and providing employment to nearly 19 million persons. The major issues hindering the growth of small scale industries are technology obsolescence, managing inadequacies, delayed payments, poor quality, incidence of sickness, lack of appropriate infrastructure, and lack of marketing network. This sector needs to be nurtured and provided strong support services for its long-term profitable growth. SIDBI tries to strike a balance between financing and providing support services for the development of SSI sector.

As an apex institution, SIDBI makes use of the network of the banks and state financial institutions, which have retail outlets for coordinating the development of the small scale sector. It has initiated a system of dialogue and obtaining feedback from the representatives of institutions of SSIs who are on the SIDBI's National Advisory Committee and Regional Advisory Committees. SIDBI has entered into (MOUs) with 18 banks, government agencies, international agencies, development institutions, and industry associations to facilitate a coordinated approach for the development of the SSI sector.

Financial Products Offered by SIDBI

SIDBI offers a chain, of financial products covering micro-finance, business, incubation, venture capital, project finance, assistance for technology development and marketing of small scale industries products, export finance, bills finance, factoring, guarantees for loans, and so on. SIDBI also provides support services such as training, market information, and advice for enhancing the inherent strength of small scale units.

Products and Services

- Direct Finance Schemes
- Bills Finance Schemes
- Refinance Schemes
- International Finance Schemes
- Marketing Finance and Development Schemes (Marketing Schemes)
- SIDBI Foundation for Micro Credit
- Other Schemes
- Promotional and Development Activities (P&D Activities)
- Fixed Deposit/Bonds

Direct Finance Schemes

1. Credit Linked Capital Subsidy (CLCS)
2. Scheme for Development of Industrial Infrastructure for SSI Sector (IID)
3. Equipment Finance Scheme (EFS)
4. Fast Track Financing Scheme (FTFS)
5. Scheme of Integrated Infrastructure Development (IID)
6. ISO 9000 Scheme (ISO 900)
7. Project Finance Scheme (PFS)
8. Tannery Modernisation
9. Technology Development and Modernisation Fund Scheme (TDMFS)
10. Technology Upgradation Fund Scheme for Textile Industries (TUFS)
11. Vendor Development Scheme (VDS)
12. Working Capital Term Loan (WCTL)

Bills Finance Schemes

1. Bills Rediscounting Scheme-Equipment (BRS-E).
2. Bills Rediscounting Scheme-Inland Supply Bill.
3. Direct Discounting Scheme-Components (DDS-C).
4. Direct Discounting Scheme-Equipment (DDS-E)

Refinance Schemes

1. Refinance Scheme for Acquisition of ISO Series Certification, by SSI Unit (RISO 9000)
2. Composite Loan Scheme (CLS)
3. Credit Linked Capital Subsidy Scheme for Technology Upgradation of Small Scale Industries (CLCSS)
4. For Term Loan-Non-SSI
5. General Refinance Scheme (GRS)
6. Mahila Udyam Nidhi (MUN)
7. National Equity Fund Scheme (NEF)
8. Refinance Scheme for Rehabilitation of Sick Industrial Units (RSR)
9. Self Employment for Ex-Servicemen Scheme (SEMFEX)
10. Single Window Scheme (SWS)
11. Refinance for Small Road Transport Operators (SRTOs)
12. Refinance Scheme for Tannery Modernisation (RTM)
13. Refinance Scheme for Technology Development and Modernisation (RTDM)
14. Refinance Scheme for Textile Industry under Technology Up-gradation Fund (RTUF)

International Finance Schemes

1. Booking of Forward Contract
2. Foreign Currency Term Loan Scheme (FCTL).
3. Line of Credit Foreign Currency (LOCFC)
5. Opening of Foreign Letters of Credit (FLC)
6. Post-Shipment Credit in Rupees
7. Pre-Shipment Credit in Foreign Currency (PCFC)

Marketing Schemes

1. Marketing Fund for Women
2. Marketing of SSI Products

SIDBI Foundation for Micro Credit

1. SIDBI Foundation for Micro Credit

Other Schemes

1. Scheme for Domestic Factoring (FAC)
2. Scheme for Invoice Discounting (IDS)

Promotional and Development Activities

1. Mahila Vikas Nidhi
2. Rural Industries Programme
3. Entrepreneurship Development Programme
4. Management Development Programmes
5. Technology Upgradation Development Programmes
6. Quality and Environment Management

Fixed Deposits/Bonds

1. Fixed Deposit Scheme
2. Capital Gains Bond
3. SIDBI's financial assistance to small scale sector is channelised through:
4. Indirect assistance to primary lending institutions (PUs)
5. Direct assistance to small units

Indirect assistance is extended by way of refinance, granting of line of credit (LOC) in lieu of refinance to and rediscounting of bills of exchange to eligible PUs including banks, state financial corporations, and state industrial development corporations having over 65,000 branches all over the country. The total number of eligible PUs as at the end of March 2001 stood at 910.

SIDBI refinances loans sanctioned and disbursed by PUs to set up new SSI projects and for expansion, technology, up-gradation, modernisation, quality promotion, diversification by existing units, and rehabilitation of sick SSI units. This refinance assistance flows to the transport, health, and tourism sectors and also to professional and self-employed persons setting up small-sized professional ventures.

SIDBI extends short-term loans to scheduled banks in respect of their outstanding portfolio relating to SSI sector against which no financial support has been availed from other institutions.

SIDBI rediscounts bills of SSI suppliers and bills arising out of sale/purchase of machinery discounted by scheduled commercial banks.

Subsidiaries

To facilitate the creation of an environment for self-sustaining and growing SSI units and to provide a completed range of services, SIDBI has set up

(i) Credit Guarantee Fund Trust for Small Industries
(ii) SIDBI Venture Capital Limited
(iii) Technology Bureau for Small Enterprises
(iv) SIDBI Foundation for Micro credit

The Credit Guarantee Fund Trust for Small Industries (CGTSI) has implemented a credit guarantee fund scheme for small industries to facilitate collateral free and third party guarantee-free credit facilities (both' long-term and working capital) from scheduled commercial banks and select regional rural banks to new and existing units in the SSI sector, including units in the information technology and software industry. The Credit Guarantee Fund Trust for Small Industries, which guarantees collateral

free/third party guarantee-free loans upto Rs 25 lakh per SSI borrower is an important credit facilitating initiative.

SIDBI's Venture Capital Limited provides venture funds for various activities such as software services and education, product development, internet services, and so on.
The Technology Bureau for Small Enterprises has been set up in association with United Nations, and Asia Pacific Centre for Transfer of Technology (APCTT). The Technology Bureau for Small Enterprises assists small enterprises in accessing the latest technologies in diverse industrial fields, both from within and outside India.

SIDBI Foundation for Micro Credit (SFMC) is creating a national network of strong, viable, and sustainable micro-finance institutions from the informal and formal financial sectors to provide micro-finance services to the poor, especially women, for setting up micro enterprises.
Besides these, SIDBI is the co-promoter of IDBI Bank Ltd., North-Eastern Development Financial Institutions (NEDFIs), SBI Factors, and Canbank factors.
Consequent upon amendments to the State Financial Corporations (SFCs) Act, State Financial Corporations have been brought under the ambit of SIDBI.
SIDBI is among top 30 development banks of the world. As per the May 2001 issue of The Banker, London, SIDBI ranked twenty-fifth both in terms of capital and assets.
Financial Results of SIDBI for the Year Ended March 31, 2002

(Rs in crore)

Particulars	*Year ended 31.03.2002*	*Year ended 31.03.2001*
1. Income from Operations	1,553	1,606
2. Other Income	6	13
Total Income (1 + 2)	1,559	1,619
3. (a) Establishment Expenses (Staff Cost)	32	39
(b) Other Expenses	45	50
4. Interest Expenses	1,069	1,044
Total Expenditure (3 + 4)	1,146	1,133
5. Depreciation	8	9
6. Profit before Tax (1 + 2 - 3 - 4 - 5)	405	477
7. Provision for Taxation	-	-
Current	-152	-
Deferred	29	-
8. Net Profit (6 - 7)	282	477
9. Paid Up Share Capital (comprising equity shares having face value of Rs 10 each)	450	450
10. Reserves (excluding revaluation reserves)	3,501	3,321
11. Earning Per Share (Rs)	6.27	10.60
12. Shareholding	No. of Shares	% of Shareholding
Financial Institutions	24,00,00,000	53.34

Insurance Companies	6,00,00,000	13.33
PSU Banks	15,00,00,000	33.33
Total	45,00,00,000	100.00

Source: SIDBI.

Resources Raised by SIDBI

SIDBI has been raising resources through international and domestic markets. It has raised borrowings from Japan Bank for International Cooperation and KfW Germany. It also raises taxable priority sector bonds from domestic markets as also deposits from foreign banks. As per the provisions of Union Budget 2002-03, SIDBI has been allowed to raise capital gains bonds. The Government of India converted SIDBI's borrowings from the Reserve Bank of India into bonds of 20 years tenure issued to GOL These bonds are eligible for inclusion in Tier - I Capital. This increased the capital adequacy ratio of the Bank from 28% in 2000-0 I to 45% in 2001-02.

SIDBI Overall Assistance: Product Groupwise

(Rs in crore)

Scheme		*1990-91*	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	*1999-200C*	*2000-01*
Refinance (including LOCs in lieu of refinance)	S	2,052.2	2,299.0	2,026.8	1,766.5	1,672.2	2,609.1	2,451.0	3,171.8	4,743.8	6,353.3	8,088.0
	D	1,561.5	1,634.5	1,450.0	1,390.9	1,235.5	2,123.7	1,941.7	2,640.2	3,247.3	4,138.1	4,411.6
Bills financing	S	266.0	463.2	753.6	1,076.9	1,642.3	2,079.7	2,008.8	1,625.8	1,678.6	1,503.5	880.5
	D	198.7	348.8	609.3	910.8	1,442.7	1,825.8	1,771.4	1,459.8	1,484.8	1,313.7	778.6
Resource Support to Institutions	S	80.5	58.8	101.3	411.3	888.9	1,091.0	1,406.1	1,447.7	1,465.4	1,320.5	792.2
	D	72.8	31.3	75.1	329.5	584.0	713.8	660.5	677.7	958.7	692.2	437.5
Project related Financing	S	3.0	13.3	16.7	93.4	489.9	267.9	583.1	1,192.6	943.6	1,021.7	995.6
	D	0	3.0	3.4	34.9	118.2	127.8	187.5	430.4	562.8	768.3	771.0
Equity assistance	S	7.1	11.7	9.9	5.9	6.0	8.0	22.7	31.1	24.8	35.6	20.2
	D	5.5	9.7	8.0	5.2	4.8	5.0	16.8	26.4	22.2	32.1	16.9
Promotional and Development Assistance	S	1.3	1.0	.9	2.3	7.0	9.9	13.6	15.2	23.6	30.1	44.0
	D	.3	.7	.5	1.4	4.6	4.7	6.8	6.2	9.4	19.1	25.8
Total	S	2,410.1	2,847.0	2,909.2	3,356.3	4,706.3	6,065.6	6,485.3	7,484.2	8,879.8	10,264.7	10,820.6
	D	1,838.8	2,028.0	2,146.3	2,672.7	3,389.8	4,800.8	4,584.7	5,240.7	6,285.2	6,963.5	6,441.4

S = Sanctions/Approvals D = Disbursement/Payments

Source: SIDBI.

Financial Highlights of SIDBI

In its twelve years of operations, the aggregate sanctions of SIDBI declined for the first time during the year 2001-02. (Table 15.13) The aggregate sanctions of SIDBI during 2001-02 amounted to Rs 9,025 crore as against Rs 10,821 crore in the previous year. Disbursements were also lower at Rs 5,919 crore as against Rs 6,441 crore in the previous year. The decline in off-take of refinance was mainly due to a slowdown in the growth of the industrial sector, moderate services sector performance, and comfortable liquidity in the banking sector. The cumulative sanctions and disbursements of SIDBI since inception stood at Rs 75,255 crore and Rs 52,312 crore showing a compounded growth rate of 13% and 11%, respectively.

SIDBI's overall operations under promotional and development assistance have shown an increasing trend and have further increased in 2001-02. The micro-finance activities registered a significant growth. I This growth was a result of financial assistance received from Department for International Development, Government of UK. SIDBI has been granted a substantial line of credit by the International Fund for Agriculture Development, Rome, a United Nations outfit, for upscaling micro-credit operations.

As regards financial performance, the income of the Bank declined in the year 2001-02. The income of the Bank was Rs 1560 crore in 2001-02 as against Rs 1,619 crore in 2000-01. The profit before tax in 2001-02 was lower at Rs 405 crore as against Rs 477 crore in 2000-01 owing to a decline in interest rates. Effective IFY 2002, SIDBI has been brought under the purview of taxes and hence it had to pay Rs 152 crore in the form I of taxes. This led to a reduction in profit after tax and earnings per share in 2001-02. The earnings per share declined to Rs 6.27 for the year ended March 31, 2002, from Rs 10.60 for the previous year. The Bank's net worth increased to Rs 3,951 crore as at end March 2002 from Rs 3,771 crore as at end March 2001. The net NPAs of the Bank increased to 3% on March 31, 2002, from 1.2% on March 31, 2001.

Conclusion

After making a beginning as essentially a refinance institution SIDBI has grown into a multifaceted organisation. It has served the small sector well by providing a wide range of products and resource support services-in its twelve years of existence. It will, however, have to change its operational strategy in view of declining interest rates and availing of refinance by"banks. SIDBI should endeavour to contain non-performing assets and build quality long-term assets and thereby become a strong and vibrant financial institution.

LESSON 30
DEVELOPMENT FINANCIAL INSTITUTIONS: MAJOR PLAYERS

Lesson Objectives: **To know in short about specific DFIs and their working.**

Role of major DFIs in Industrial Growth

We continue our discussion in this session about specific DFIs.

INFRASTRUCTURE DEVELOPMENT FINANCE COMPANY LTD

Infrastructure Development Finance Company Limited (IDFC) was set up on the recommendations of the Expert Group on Commercialisation of Infrastructure Projects under the Chairmanship of Dr. Rakesh Mohan. The group identified the need for a specialised financial intermediary for infrastructure to professionalise the process of infrastructure development in the country. IDFC was incorporated on January 30, 1997, with an initial paid up capital of Rs 1,000 crore. The Government of India and the Reserve Bank of India have contributed Rs 650 crore by way of subordinated debt, raising its total capitalisation to Rs 1,650 crore. Domestic financial institutions such as HDFC, ICICI Ltd., IFCI Ltd., SBI, and UTI have contributed 20% of the share capital; foreign shareholding is 40%; and government shareholding constitutes 40% of the total capital.

IDFC was set up to facilitate the flow of private finance to commercially viable infrastructure projects. The traditional sources of finance could not meet the financing needs of such projects as the risk profile of infrastructure projects is unique. IDFC has designed innovative products and services to address the specific needs of infrastructure financing. The mission of IDFC is leading private capital to commercially viable infrastructure projects by advocating solutions that deliver efficient services to consumers.

Initially, IDFC focused on power, roads, ports, and telecommunications. Now it has broadened this focus to the framework of energy, telecommunications and information technology, integrated transportation, urban infrastructure, and food and agri-business infrastructure.

IDFC has been assigned lead manager mandates and key advisory assignments. In its role as policy advisor, IDFC provides leadership in rationalising policy and regulatory frameworks and removes impediments to the movement of capital to infrastructure sectors. To facilitate the role of policy advisor, IDFC identifies best products, draws on the expertise of policy advisory boards and promotes policy dialogue amongst key players in the various infrastructure projects. IDFC also provides finance by way of equity and debt support. It also strengthens links between financial institutions and infrastructure projects by encouraging financial institutions to participate in infrastructure projects.

IDFC's Operations

Energy : IDFC provides consultancy and advisory services to state governments for formulating a power sector strategy. It prepares road maps for reform initiatives in respect of the policy framework governing the power sector with a belief that its multi-pronged and focused approach to reforming the power sector would ultimately translate into desired investment opportunities. It also acts as a lead arranger and financier for power projects.

IDFC played a pivotal role in the preparation of the report of the Government of Karnataka's High Level Committee on Escrow cover to Independent Power Projects. IDFC is part of the consortium acting as a privatisation consultant to Karnataka Power Transmission Company Limited, the monopoly state public sector company engaged in transmission and distribution of power. IDFC has provided financial advisory services and prepared a detailed fuel study for the Torrent Group's proposed power generation plant. It also interacts with and responds to documents released by the Central Electricity Regulatory Commission (CERC) and various State Electricity Regulatory Commissions.

As on June 30, 2002, Rs 4,122 crore were approved to 37 projects and Rs 779 crore were disbursed to 13 projects.

Food and Agriculture Business Infrastructure : This initiative was launched in August 2000. IDFC entered this sector with a belief that this sector has immense growth potential and the private sector has an important role to play to complement initiatives of the government. It has entered into a strategic alliance with Rabo bank, the Netherlands, a pioneer in the food and agriculture business, to provide the F&A industry in India with unique solutions for the development of its infrastructure.
Integrated Transportation IDFC views integrated transportation as an integrated logistics chain with parts not only complementing each other but also competing with each other. Hence roads, railways, pipelines, waterways, ports, and airports are links of a chain and not stand alone, independent entities.
IDFC has approved Rs 1,980 crore to 24 projects and has disbursed Rs 758 crore to ten projects till June 30, 2002.

Telecommunications and IT Infrastructure : IDFC has provided financial assistance to various telecom services projects in the areas of cellular mobile, basic national long distance, cable and broad band, and satellite services provision. IDFC's major clients are private sector telecommunication service players. It has provided assistance on a non- or limited-recourse basis, with project sizes ranging from Rs 20 crore to Rs 5,000 crore and loan periods varying from one to ten years.
IDFC has consolidated its operations in cellular industry with 60% of assistance provided to cellular mobile telephony service providers. It has played a key role in the two initial public offers by the new telecom companies as underwriter and anchor investor. It also provides performance and financial guarantees. Telecom and IT assets comprised 50% of IDFC's total assets as on March 31,2002.

Urban Infrastructure : IDFC provides financing and project advisory services for the development of urban infrastructure. It helps the state governments to prepare a road map for private sector participation in the development of urban infrastructure. IDFC played a key role in the Committee for Operation and Maintenance of Rural and Urban Water Supply Schemes constituted by the Government of Maharashtra. It has also entered into an agreement with the Asian Development Bank for a line of credit amounting to US $30 million for financing urban and environmental infrastructure projects. It is also a member of the Steering Committee for financing bankable solutions for waste-to-energy projects in Mumbai. IDFC has so far approved Rs 372 crore to eight projects and disbursed Rs 38 crore to five projects.
Environment Management : IDFC recognised the importance of environment risk management for infrastructure project financing and set up a separate Environmental Management Group (EMG) to help projects address environment risks.

Decentralised Infrastructure and New Technologies : IDFC created a decentralised infrastructure and new technologies group to undertake initiatives such as identification of new technologies for application, development of financial models with the help of a local service partner, and initiating dialogue with donor agencies, relevant ministries, and multi-lateral agencies to enable and stimulate commercially viable decentralised development.
3i Network : It has set up 3J Network comprising of university network including lIT, Kanpur, and TIM, Ahmedabad, to harness the best academic expertise for developing and strengthening the infrastructure framework in the country.

Infrastructure Finance Company (Gujarat) Limited : This is a company set up in Gujarat by IDFC, Gujarat Industrial Investment Corporation (GIIC), and AIA Capital of the USA. This company is intended to be a conduit to direct funds by way of equity and debt, from the capital market to infrastructure projects in Gujarat. IFC(G) will act as an asset management company with the mandate to raise Rs 4,500 crore for infrastructure projects in the state over the next five years. It will manage the Gujarat Infrastructure Fund (GIF), which has incorporated an Equity Fund and a Debt Fund under the Indian Trusts Act.

Financial Highlights of IDFC
Financial Performance of IDFC
(Rs in crore)

	FY 2002	*FY 2001*	*FY 2003*
	For the year ended 31.3.2002	*For the year ended 31.3.2001*	*For the period 1.4.02 to 30.6.02*
Total Income	405.30	314.90	95.74
Less: Total Expenses	203.67	158.46	47.16
Profit before Tax	201.63	156.44	48.58
Less: Provision for Tax	15.00	16.00	5.00
Profit after Tax	186.63	140.44	43.58
Add: Balance Brought Forward	342.23	305.13	-
Total Available for	528.86	445.57	-

Appropriation			

Source: IDFC

15.15 Operational Highlights of IDFC

(Rs in crore)

	FY 2001		*FY 2002*		*FY 2003*	
	Approvals	*Disbursements*	*Approvals*	*Disbursements*	*Approval*	*Disbursements*
Energy	1,041	222	382	156	80	3
Telecommunications And LT.	1,660	495	1,545	817	0	105
Integrated Transportation	539	42	803	496	200	47
Urban infrastructure	27	4	278	32	0	2
Total	3,267	763	3,008	1,501	280	157

Source: IDFC.

IDFC's Exposure to Various Sectors (2001-02)

(In percentage)

Telecommunication	37.26
Energy	29.43
Transportation	27.70
Urban Infrastructure	5.61

Source: IDFC

IDFC's Sanctions and Disbrsements

Year	*Sanctions (Rs in crore)*	*Growth rate (in percentage)*	*Disbursement (Rs in crore)*	*Growth rate (in percentage)*
1997-98	295.00	-	-	-
1998-99	1,682.00	470.2	375.00	-
1999-2000	1 ,866.00	10.9	642.00	71.2
2000-01	2,467.00	32.2	762.00	18.7
2001-02	3,008.00	21.9	1,501.00	96.9
Cumulative up to end March 2002	10,123.40 (including performance .and financial guarantees for 86 projects)			

Source: IDFC.

Financial Ratios of IDFC

	Financial Year	
	2002	2001
Interest Income as a Percentage to Average Working Funds	11.74	10.59
Non Interest Income as a Percentage to Average Working Funds	1.10	1.22
Operating Profit As a Percentage to Average Working Funds	6.62	6.43

Return. On Average Assets (in percentage)	5.91	5.26
Net Profit Per Employee (in rupee crores)	1.61	1.35

Source: IDFC

IDFC's approvals and disbursements have increased in its five years of existence. IDFC's disbursements have almost doubled in the year 2001-02 as compared to 2000-01. The total disbursements amounted to Rs 1,501 crore for 24 projects during 2001-02 as against Rs 763 crore from 15 projects in 2000-01.

The outstanding disbursements as on March 31, 2002, were Rs 2,851 crore. Its exposure to Gujarat was the highest (Rs 1,662 crore) followed by Maharashtra (Rs 802 crore) and Andhra Pradesh (Rs 536 crore). IDFC's sanctions and disbursements to telecommunications and information technology was the highest. Its exposure to telecommunications and information technology increased 37.26% in 2001-02.

The profits before tax and after tax increased in the year 2001-02. This increase was mainly due to rise in operating and interest income. The total assets of IDFC increased from Rs 27,822 million in 2000-01 to Rs 31,189 million in 2001-02. As on March 31, 2002, IDFC had nil non-performing assets.

Conclusion

IDFC has evolved a vision for core sectors such as power, ports, roads and telecom where cost-effective services to the end user is the ultiinate goal of infrastructure provision. This vision is based on its belief that the key to reform in infrastructure is in introducing competition. It has successfully financed innovative projects in its five'years of existence. In order to provide a thrust to the infrastructure financing programme, IDFC will be merged with the Infrastructure Leasing and Financial Services (IL&FS). This new company will be the country's biggest infrastructure financing company.

THE EXPORT-IMPORT BANK OF INDIA

The Export-Import Bank of India (Exim Bank) is a public sector financial institution created by an Act of Parliament-the Export-Import Bank of India Act, 1981. It commenced its business operations in March 1982. It is wholly owned by the Government of India and was set up for the purpose of financing, facilitating, and promoting foreign trade in India. Exim bank is the principal financial institutions in the country for coordinating working of institutions engaged in financing exports and imports.

Exim Bank is an apex institution which promotes foreign trade. Its head office is Mumbai. It has a network of 13 offices in India and overseas.

Objectives

a. *Financing, facilitating, and promoting India's foreign trade.*
b. *Creating export capability by arranging competitive financing at various stages of the export cycle.*
c. *Developing commercially viable relationships with a target set of externally oriented companies by offering them a comprehensive range of products and services, aimed at enhancing their internationalisation efforts. The vision of Exim Bank is "To offer best-in-class services to our customers in their*

globalisation efforts through the creation of an environment for our people that rewards excellence, initiative and innovation."

Exim Bank: Business Profile

The operations of the Bank are grouped as below:

Export credits

The Bank provides export credit on deferred payment terms on exports of Indian machinery, manufactured goods, consultancy, and technology services.

Lines of credit/buyer's credits are extended to overseas entities, that is, governments, central banks, commercial banks, development finance institutions, regional development banks for financing export of goods and services from India.

The Bank also provides:

(i) Project Finance
(ii) Trade Finance

Export capability creation

- Export product development
- Export marketing finance
- Export oriented units
  (i) Project finance
  (ii) Working capital
  (iii) Production equipment finance
- European Community Investment Partners (ECIP)
- Asian Country Investment Partners (ACIP)
- Overseas Investment Finance
- Export facilitation programs
  (i) Software training institutes
  (ii) Minor ports development

Export services

In addition to finance, the Bank provides a range of information and advisory services to Indian companies to supplement their efforts aimed at globalisation of Indian business.

Supporting groups

1. Planning and research
2. Accounts/MISIEDP
3. Legal
4. Coordination
5. HRD
6. Establishment

Exim Bank provides a range of programs which can be classified into

(i) Financing programs
(ii) Export services and export promotion programs

Financing Programmes : Exim Bank provides financial assistance to Indian companies by way of a variety of lending programmes, namely, non-funded and funded lending programmes. Non-funded lending programmes include bid bond, advance payment guarantee, performance guarantee, guarantee for release of retention money, guarantee for raising borrowings overseas, and other guarantees. Funded lending programmes include pre shipment rupee credit, post-shipment rupee credit,

foreign currency loan, overseas buyers credit, lines of credit, loan under FREPEC Programme, and refinance of export loans.

Exim Bank also provides financial assistance to Indian companies for export capability creation by way of a lending programme for export oriented units, production equipment finance programme, import finance, export marketing finance programme, software training institutes, financing, research and development, and programme for export facilitation. The programme for export facilitation includes port development, export vendor development lending programme, foreign currency pre-shipment credit, and working capital term loan programme for export oriented units.

Export Services and Export Promotion Programmes Exim Bank provides a range of export related services. The Bank's fee-based services help identify new business propositions, source trade, and investment -related information, create and enhance presence through joint network of institutional links across the globe, and assist externally oriented companies in their quest for excellence and globalisation. It also provides services such as search for overseas partners, identification of technology suppliers, negotiating alliances, and development of joint ventures in India and abroad. The Bank also supports Indian project exporters and consultants to participate in projects funded by multilateral funding agencies.
It also extends assistance to Indian promoter companies in setting up of joint ventures through the Overseas Investment Finance Programme (OIF) and the Asian Countries Investment Partners (ACIP) programme.
Exim Bank plays the role of an intermediary for facilitating the forfaiting transaction between the Indian exporter and the overseas forfaiting agency. It also set up a new company, the Global Trade and Finance Private Limited in association with West LB, Germany, and IFC Washington to offer export factoring and forfaiting to Indian exporters.

The Bank undertook new initiatives during 2000-01. It launched a new programme in association with EBRD, London, to support Indian exports to 26 countries. It also entered new businesses like venture capital finance and brand promotion in Europe.
Financial Highlights of Exim Bank
Sanctions and Disbursements by EXIM Bank

Year	*Sanctions*		ursements	
	Funded Assistance (Rs in crore)	*Guarantees (Non-funded Assistance)*	*Funded assistance (Rs in crore)*	*Guarantees (Non-funded assistance)*
1996-97	1,242.1	136.5	1,256.6	148.1
1997-98	1,840.6	402.4	1,370.4	191.2
1998-99	1,838.0	263.5	1,270.7	247.4
1999-2000	2,831.8	440.4	1,729.6	301.7
2000-01	2,174.3	211.8	1,896.4	174.1
2001-02	4,241.0	545.0	3,453.0	416.0

Source: IDBI, *Report on Development Banking in India, 2000-01* and EXIM Bank.
Income and Expenditure Account of EXIM Bank

(Rs in crore)

		1999-2000	*2000-01*
A.	Expenditure		
1.	Payment of interest	364.49	451.98
2.	Other expenditure	33.81	36.74
3.	Tax	62.25	50.55
4.	Profit after tax	165.05	154.15
	Total	625.60	693.42
B.	Income		
1.	Interest and discount	602.01	673.95
2.	Exchange, commission, brokerage, and fees	22.51	17.93
3.	Others	1.08	1.54
	Total	625.60	693.42

Asset Classification of EXIM Bank
(In percentage)

	1999-2000	*2000-01*	*2001-02*
Standard assets	92.7	91.9	92.6
Substandard assets	3.9	4.7	7.4
Doubtful assets	3.4	3.45	-
Total	100.0	100.0	100.0

Source: EXIM Bank.

Financial Ratios of EXIM Bank

		1996-97	1997-98	1998-99	*1999-2000*	*2000-01*
1	Profit after tax to average net worth (%)	15.5	17.9	13.0	11.4	9.9
2	Profit after tax to average assets (%)	3.4	4.0	3.1	2.6	2.1
3	Average cost of funds (%)	5.9	5.6	5.4	5.8	6.3
4	Average return of funds (%)	9.8	10.0	10.3	9.9	9.6
5	Margin (%)	3.9	4.4	4.9	4.1	3.3
6	Debt equity ratio	2.9	2.5	2.6	2.9	2.8
7	Capital adequacy ratio (%)	31.5	30.5	26.6	24.4	23.8

Source: IDBI, *Report on Developing Banking in India, 2000-01.*

The sanctions and disbursements under various financing programmes were the highest in the year 200102. During 2001-02, the Bank sanctioned Rs 4,241 crore under various lending programmes as against Rs 2,174 crore in the year 2000-01, registering a growth of 95.1%. Disbursements during the year 2001-02 were Rs 3,453 crore as against Rs 1,896 crore during 2000-01 representing a growth of 82.1%. Outstanding disbursements as at end March 2002 were Rs 6,610 crore registering an increase of 17.1% over the previous year.

The Bank sanctioned guarantees aggregating Rs 545 crore during 2001-02 as against Rs 212 crore during 2000-01. Guarantees issued amounted to Rs 416 crore during 2001-02 as against Rs 174 crore during 2000-01. The outstanding guarantees as at end March 31, 2002, amounted to Rs 1,127 crore. These guarantees related to overseas projects in sectors such as telecommunication, power generation, transmission and distribution, oil exploration, cement and petrochemicals.

During the year 2001-02, total 59 contracts worth Rs 4,162 crore covering 26 countries, were secured by 34 Indian exporters, with the Bank's support as against 38 contracts worth Rs 1,833 crore covering 23 countries during 2000-01. The contracts consisted of 27 turnkey contracts valued at Rs 3,051 crore, 19 supply contracts at Rs 703 crore, 11 service contracts valued at Rs 274 crore and 2 construction contracts at Rs 134 crore.

The Bank registered profit before tax (PBT) of Rs 221 crore during 2001-02 as against Rs 205 crore during 2000-01. The profit after tax (PAT) amounted to Rs 171 crore during 2001-02 as against Rs 154 crore during 2000-01, registering a growth of 11%. Its net assets grew by 17% during the year 200102. The Bank paid a dividend of Rs 42 crore to the government in the year 2002.
Conclusion

Exim Bank has reoriented its strategies looking to the changing dynamics of international trade and global environment. It caters not only to the financing needs of exporters and importers but also supports Indian companies in their effort to globalise their business. These new initiatives have helped the exporters and importers to secure more business which, in turn, has led to an increase in the Bank's assets and profits.

NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

The National Bank for Agriculture and Rural Development (NABARD), a development bank, came into existence on July 12, 1982, under an Act of Parliament with an initial capital of Rs 100 crore. It is an apex institution set up for providing and regulating credit and other facilities for the promotion and development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts, and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto.

NABARD took over the functions of the erstwhile Agricultural Credit Department (ACD) and Rural Planning and Credit Cell (RPCC) of REI and Agricultural Refinance and Development Corporation (ARDC). Its subscribed and paid up capital was Rs 100 crore which was enhanced to Rs 500 crore, contributed by the Government of India (GOI) and the Reserve Bank of India (RBI) in equal proportions. The capital is now enhanced to Rs 2,000 crore.

Functions of NABARD

(i) It serves as an apex refinancing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas.

(ii) It takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, and so on.

(iii) It coordinates and supervises the rural financing activities of all institutions engaged in developmental work at the field level and maintains liaison with the Government of India, state governments, Reserve Bank of India, and other national level institutions concerned with policy formulation.

(iv) It undertakes monitoring and evaluation of projects refinanced by it.

(v) It promotes research in the fields of rural banking, agriculture, and rural development.

(vi) It prepares annual rural credit plans for all districts in the country which form the base for annual credit plans of all rural financial institutions.

NABARD operates throughout the country through its 28 regional offices and one sub-office, located in the capital of all the states/union territories. It has 320 district offices across the country and one special cell at Srinagar. It has also set up five training centres.

Refinance: NABARD's mission is accelerated capital formation to promote sustainable and equitable agriculture and rural prosperity with refinance as lever.
The institutions eligible for refinance are state cooperative agricultural and rural development banks (SCARBs), regional rural banks (RRBs), state cooperative banks (SCBs), commercial banks (CBs) state agricultural development finance companies (ADFCs), and primary urban cooperative banks.

NABARD extends refinance for both farm and non-farm sector. Long-term investment for farm sector includes investment on agriculture and allied activities such as minor irrigation, farm mechanisation, land development, soil conservation, dairy, sheep rearing, poultry, piggery, plantation, horticulture, forestry, fishery, storage and market yards, biogas and other alternate sources of energy and so. Non-farm sector includes investment activities of artisans, SSI, tiny sector, village and cottage industries, handicrafts, handlooms, and others. NABARD extends automatic refinance facility for refinance limit up to Rs 20 lakh.

NABARD's special focus is on the removal of regional/sectoral imbalance and hence gives preference to the needs of north-eastern states in terms of allocation of resources, quantity of refinances, and so on. Besides this, its focus is on hi-tech and export-oriented projects. It has issued guidelines for formation of hi-tech and export-oriented projects in farm and non-farm sectors. It also undertakes consultancy work for projects. It has set up ADFCs in Andhra Pradesh, Tamil Nadu and Karnataka for financing hi-tech/commercial ventures. NABARD is the chief promoter of these ADFCs with a holding of 26% equity.

NABARD provides short-term refinance for various types of production/ marketing/ procurement activities. NABARD provides refinance facilities to:

(i) SCBs and RRBs for financing seasonal agricultural operations (SAOs), which include plugging and preparing land for sowing and weeding, and labor for all operations in the fields for raising and harvesting the crops.

(ii) SCBs/CBs for financing the requirements of Primary Weavers' Cooperative Societies (PWCS), Apex Regional Weavers Societies, and State Handloom Development Corporations (SHDCs) to benefit the weavers outside the cooperative fold.

(iii) RRBs for financing artisans and village/cottage/tiny sector industries as also for financing persons, belonging to the weaker sections and engaged in trade/business/service.

(iv) SCBs on behalf of District Central Cooperative Banks (DCCBs) for (a) financing farmers to hold on to their produce till they get remuneration price of their produce (b) procurement, stocking, and wholesale distribution by apex societies and retail distribution of fertilisers to farmers.

Other refinance facilities include conversion assistance in case of natural calamity, long-term loans to state governments, financing of state handicrafts development corporations, financing of industrial cooperative societies and forest labour cooperative societies, and medium-term credit limits to SCBs and RRBs.

Types of Refinance Facilities

Agency	*Credit Facilities*
Commercial Banks	. Long-term credit for investment purposes . Financing the working capital requirements of Weavers' Cooperative Societies (WCS) and State Handloom Development Corporations
Short-term Co-operative Structure (State Cooperative banks. District Central Cooperative Banks, Primary Agricultural Credit Societies)	. Short-term (crop and other loans) . Medium-term (conversion) loans . Term loans for investment purposes . Financing WCS for production and marketing purposes . Financing State Handloom Development Corporations for working capital by State Cooperative Banks
Long-term Cooperative Structure (State Cooperative Agriculture and Rural Development Banks, Primary Cooperative Agriculture and Rural Development Banks)	. Term loans for investment purposes
Regional Rural Banks (RRBs)	. Short-term (crop and other loans) . Term loans for investment purposes
State Governments	. Long-term loans for equity participation in cooperatives

Non-Governmental Organisations (NGOs)-Informal Credit Delivery System	. Rural Infrastructure Development Fund (RIDF) loans for infrastructure projects . Revolving Fund Assistance for various micro-credit delivery innovations and promotional projects under Credit and Financial Services Fund (CFSF) and Rural Promotion Corpus Fund (RPCF), respectively

NABARD also extends refinance to banks for financing government-sponsored programmes such as Swamajayanti Gram Swarozgar Yojana, Prime Minister's Rozgar Yojana, action plans of SC/ST Development Corporations, and for development of non-conventional energy sources.

Rural Infrastructure Development Fund

The development of a strong rural infrastructure is a prerequisite for increasing productivity of land, capital and labour, improving the quality of life, and reducing vulnerability of rural power. Rural infrastructure includes irrigation structures, rural lands, bridges, water supply, sanitation, rural energy, rural market yards, education, health, communication, and information technology. Investment in rural infrastructure creates new economic opportunities and activities, generates additional employment and income, and facilitates and improves delivery of other rural services.

Investment in rural infrastructure declined in the eighth five year plan period. The state governments failed to develop and maintain rural infrastructure due to resource crunch. Moreover, the commercial banks which were to channelise at least 18% of their total lending to agriculture were unable to fulfill their commitment. To provide loans to state governments for the creation of rural infrastructure at reasonable rates, RIDF was set up in 1995-96 under the initiative of the Central Government. The scheme is operationalised by NABARD. Under the scheme, the central government through budgetary outlays, contributes to the corpus fund of RIDE

RIDF was set up with an initial amount of Rs 2,000 crore, (RIDF I). The Tranche-I was made up of contributions by way of deposits from scheduled commercial banks operating in India to the extent of shortfall in their agriculture lending, subject to a maximum of 1.5% of the net bank credit. In the years 1996-97 and 1997-98, the Union Budgets allocated Rs 2,500 crore. In the subsequent tranches, this amount was raised to Rs 3,000 crore in 1998-99, Rs 3,500 crore in 1999-2000, Rs 4,500 crore in 2000-01, Rs 5,000 crore in 2001-02 and Rs 5,500 crore in 2002-03. In order to encourage commercial banks to directly lend to priority sector, interest rates earned by commercial banks on RIDF deposits are kept inversely related to the shortfall in lending to agriculture. Further, credit risk weights for both direct priority sector lending and RIDF deposits had been fixed at 100%.

The Corpus, Amount Sanctioned, Phased and Disbursed Under RIDF

(Rs in crore)

RIDF Tranche	*Corpus*	*Amount Sanctioned*	*Amount phased*	*Amount Disbursed*
RIDFI	2,000	1,911	1,911	1,761
RIDF II	2,500	2,620	2,620	2,250
RIDF III	2,500	2,693	2,693	2,183
RIDF IV	3,000	2,988	2,988	1,863
RIDFV	3,500	3,568	3,568	1,969
RIDFVI	4,500	4,586	3,872	1,899
RIDFVII	5,000	5,066	1,479	1,117
Total	23,000	23,432	19,131	13,042

Excluding schemes withdrawn.
Source: RBI, Report on Trend and Progress of Banking in India, 2001-02.
The corpus of RIDF I to VII taken together amounted to Rs 23,000 crore as on March 31, 2002. Cumulative amounts of deposits mobilised, loans sanctioned, and fund disbursed under RIDF as on March 31, 2002, were Rs 12,288 crore, Rs 23,432 crore, and Rs 13,042 crore, respectively.

RIDF is used to finance incomplete or ongoing projects in minor, medium, and major irrigation along with flood protection, watershed management, and soil conservation. It also includes activities such as construction of rural roads and bridges, harvesting of rain water and construction of terminal rural markets, fish jetties and cold storage, primary school buildings, primary health centres, village *haats*, *anganwadi* centres, *shishushiksha kendras*, forest management, mini hydel and system improvement projects under power sector, rural drinking water supply, and citizens' information centres under IT sector..

Loans under RIDF are sanctioned up to 90% of the project cost. Ongoing incomplete projects and projects with shorter gestation period are accorded priority. 43,478 projects involving a loan amount ofRs 5,066 crore were sanctioned under RIDF during 20014>2. Rural roads and bridges accounted for 48.4% of the amount sanctioned while irrigation accounted for 23.6%. The total amounted sanctioned till July 5, 2002, was Rs 24,398.35 crore wherein roads and bridges accounted for 52.31%, irrigation accounted for 34.36%, watershed 1.64% and others 11.69%. As at the end of March 2002, of the 2,33,235 projects sanctioned, 1,34,636 projects were completed.

Other Schemes

(i) *Kisan Credit Card (KCC) Scheme* : This scheme was started in 1998-99 to grant credit to farmers. During the year 2001-02, 83.821akh cards were issued by cooperative banks, RRBs and CBs. Since inception up to the end of March 2002; 2.32 crore KCCs have been issued of which RRBs and cooperative banks issued 1.65 crore KCCs involving a credit limit of Rs 33,994 crore.

Loans disbursed under KCCs have been brought under Rashtriya Krishi Bima Yojana of the General Insurance Corporation. KCC holders are also being provided personal accident insurance cover of Rs 50,000 for death and Rs 25,000 for disability.

(ii) *Watershed development fund* : This fund was created in NABARD in 1999-2000 with a corpus of Rs 200 crore contributed equally by the Government of India and NABARD for implementing watershed projects in 100 priority districts of 14 states. This programme includes the improvement of productivity of land, groundwater recharge, and conservation of soil and moisture. As on March 31, 2002, 119 Capacity Building Phase Projects have been sanctioned in 9 states. During the year 2001-02,106 new projects involving a grant support of Rs 5.44 crore were approved.

(iii) *Scheme for setting up of agri-clinic and agriculture centers* : During the year 2001-02, NABARD formulated a scheme for financing agriculture graduates for setting up agri-clinics and agribusiness centers.

(iv) Scheme for financing farmers for purchase of land for agricultural purposes.

(v) Scheme for ex-servicemen taking up self-employment activities under SEMFEXII.

(vi) In 1998, the GOI in collaboration with NABARD launched a central sector capital subsidy scheme (Investment Promotion Scheme) for development of privately owned non-forest wastelands in the country.

(vii) Refinance scheme for financing farmers' service centres set up in collaboration with Mahindra Shubhlabh Services Limited (MSSL) for providing various extension services to farmers, including supply of agri inputs.

(viii) Micro finance development fund: NABARD has set up a Micro Finance Development Fund with an amount of Rs 100 crore, in pursuance of the proposal contained in the Union Budget 20004>1. The Fund has received an initial contribution of Rs 100 crore contributed by the RBI, NABARD, and 11 Public Sector Commercial Banks. NABARD has further contributed Rs 6 crore from its surpluses to the fund. This fund helps in furthering the cause of banking with the poor. Over 7.9 million poor households have gained access to the formal banking system through 458 thousand Self-Help Groups (SHGs) More than 90% SHGs have exclusively women members. SHG-bank linkage programme covered 488 districts in 30 states and union territories (UTs). During the year 2001-02, Rs 5,454.59 trillion were disbursed by banks as loans to SHGs. Cumulatively, as on March 31,2002, banks have disbursed more" than Rs 1,000 crore as loans to about 4.6 lakh SHGs and availed of Rs 794 crore as refinance from NABARD. On-time repayment of bank loan was above 95% from SHG members. NABARD has provided upto March 31, 2002, Revolving Fund Assistance (RFA) of Rs 104 million to 26 NGOs, SHG Federations, and credit unions for on-lending to SHGs and to build their financial intermediation capacities.

The SHG bank linkage programme is perhaps the largest micro-finance programme of the world in terms of its outreach. Today, over 2000 non-government organisations (NGOs) and 17,000 branches of 444 banks re associated with the programme. Cumulatively, over 50,000 bank officers and 1,200 faculty members of training colleges of banks have been trained by NABARD.

Amendments to NABARD Act, 1981

Comprehensive amendments to NABARD Act, 1981, were made to provide operational flexibility to the bank in meeting the changing requirements of the rural sector. These amendments were made effective from February 1, 2001. The amendments relate to explicit reference to NABARD as a development bank, Enhancement of capital limit from Rs 500 crore to Rs 5,000 crore, allowing holding of private equity up to 49 % with a minimum of 51% by the Government of India and RBI, flexibility in resource mobilisation ld credit-delivery by the bank, introduction of new products, and setting up of subsidiaries.

NABARD as a Consultant

NABARD has recently (2003) set up its own consulting wing called NAB CON for loan seekers. The new wing is established to provide information, technical guidance, critical ideas and consultancy services to the entrepreneurs, banks, co-operatives, government and non-government organisations. The bank's wing in India as well as in the international level has on date projects worth about $200 million under consultancy, or in active consideration.

NABARD as a Regulator

NABARD was set up under the aegis of RBI for supervision and refinance of rural cooperatives. It presently supervises 29 state cooperative banks (SCB), 367 district central cooperative banks, (DCCB), 804 primary agricultural societies, and 196 regional rural banks (RRBs).

Financial Highlights of NABARD

The profits before tax during 2001-02 were Rs 1,481 crore representing a 9.4% increase over last year. le profit after tax during the year 200 1-02 was lower than the previous year due to provision for tax. NABARD was exempted from income tax on its income U/s. 55 of NABARD Act, 1981, till March 31, 2001.

During the year 2001-02, the aggregate financial support provided to banks and state governments reached a new height of about Rs 21,146 crore compared to Rs 19,518 crore during the previous year. Investment ~dit constituted Rs 6,682.77 crore, production credit Rs 9,396.76 crore and RIDF Rs 5,066.12 crore.

Under investment credit, SCARDBs availed the highest amount of refinance (42% of total disbursements), followed by commercial banks at 24%, RRBs at 18%, and SCBs at 16%. among the states, UP availed the highest amount of refinance followed by Maharashtra, Andhra Pradesh,

Financial Highlights of NABARD for the Year Ended March 31, 2002

(Rs in crore)

	Year ended 31.3.2002	Year ended 31.3.2001
Particulars		
1. Income from Operations	3,636.38	3,036.50
2. Other Income	22.28	8.50
3. Total Expenditure		

(a) Staff Cost	194.87	171.96
(b) Other Expenditure	84.00	76.54
4. Interest Expenses	1,869.11	1,415.23
5. Depreciation	30.01	27.17
6. Gross Surplus before Taxation (1 + 2 - 3 - 4 - 5)	1,480.67	1,354.10
7. Provision for Taxation	365.00	0.00.
8. Surplus after Taxation (6 - 7)	1,115.67	1,354.10
9. Contribution to NRC Funds and Special Reserve U/s. 36(1)(viii) of IT Act, 1961 # 1005.001200.00	1,005.00	1,200.00
10. Surplus after Contribution to NRC Funds and Special Reserve 110.67154.10	11 0.67	154.10
11. Paid Up Capital	2,000.00	2,000.00
12. Reserves (excluding revaluation reserve)		
(a) General Reserve	2,757.11	2,583.06
(b) Other Reserves	908.21	365.70
(c) National Rural Credit Funds	13,975.00	13,438.00

** NABARD was exempted from income tax on its income u/s. 55 of NABARD Act, 1981, till March 31, 2001. # There is no outside obligation on these funds.*

Source: NABARD.

Tamil Nadu, and Punjab. Purpose-wise, farm mechanisation's share was the highest (20%) followed by non-farm sector (16%), dairy development (10%), and minor irrigation (10%).

The total assets of NABARD as on March 31, 2002, were Rs 45,099 crore representing a 16.2 percent growth over the previous year. The net NPAs were Rs 0.93 crore forming 0.0001% of its loans and advances.

NABARD has played a key role as an apex level development finance institution committed to rural prosperity. its performance has been satisfactory in all areas of its operations. It has introduced new schemes and chalked out new strategies for better achievements in future.

INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA LIMITED (ICICI)

ICICI was among the first development banks in the world to be set up in the private sector. It was formed in 1955 at the initiative of the World Bank, the Government of India, and representatives of Indian industry. The principal objective was to create a development financial institution for providing medium-term and long-term project financing to Indian business.

ICICI played a catalytic role in the industrial development of India. It became a major source of foreign currency loans from multilateral agencies and international financial markets. ICICI was the first Indian borrower to raise the West German loan of DM 5

million from Kredianstalt (KfW) without a Gal guarantee in 1961, European currency units in 1982, and ADB loans in 1986. ICICI was the first Indian entity to float in 1986 a public issue of 75 million Swiss francs in the Swiss capital markets. It signed a loan agreement in 1987 for 10 million sterling with Commercial Wealth Development Corporation (CDC), the first loan by CDC for financing projects in India. ICICI was the first Indian financial company to raise Global Depository Receipts (GDR) in 1996 and the first financial institution from non-Japan Asia to list on the New York Stock Exchange (NYSE) through an issue of American Depository Shares (ADS) in 1999.

In 2001, ICICI raised a foreign currency loan of USD 75 million at LIB OR plus 70 basis points, setting a new benchmark for a five year borrowing by an Indian entity in the international markets after the Asian currency crisis.
ICICI successfully raised funds from the domestic market also. ICICI made its first debenture issue of Rs 6 crore in 1967 which was oversubscribed. ICICI raised financial resources from retail investors through various public offerings of bonds.
Following the economic liberalization of the Indian economy, ICICI Limited has renamed itself as ICICI.

Institutes Promoted by ICICI

ICICI initiated setting up of development institutions in the field of housing and state level industrial development. ICICI promoted specialised institutions in the areas of credit rating, venture capital, investment banking, and asset management.
ICICI promoted Shipping Credit and Investment Company of India Limited (SCICI) in 1986 which was later merged with ICICI in 1996. ICICI along with UTI set up the Credit Rating Information Services of India Limited (CRISIL), India's first professional credit rating agency, in1986. In 1988, ICICI promoted TDICI India's first venture company limited. In 1996, ICICI set up, ICICI Securities and Finance Company Limited in joint venture with J P Morgan. In 1994, ICICI promoted the ICICI Bank, marking its first foray into retail banking. ICICI diversified into merchant banking and leasing operations. ICICI took over ITC Classic Finance and Anagram Finance in 1997 and 1998, respectively. In 2000, ICICI acquired the Bank of Madura Limited to increase its retail deposit base.

The year 2002 marked a turning point in the history of the ICICI group. ICICI Limited was merged with ICICI Bank. ICICI, ICICI Personal Financial Services Limited (ICICI PFS), and ICICI Capital Services Limited (ICICI Capital) were amalgamated with the bank with effect from March 30, 2002. ICICI PFS, a subsidiary of ICICI, was acting as a focal point for marketing, distribution and servicing the retail product portfolio of ICICI, including auto loans, commercial vehicle loans, credit cards, and consumer loans. ICICI Capital, a subsidiary of IClCI, was engaged in sales and distribution of various financial and investment products such as ICICI Bonds, Fixed Deposits, Demat Services, and Mutual Funds. ICICI was the first to start internet banking and web-based securities trading through its subsidiary ICICI Web Trade Limited.

Merger of ICICI with ICICI Bank

ICICI and ICICI Bank, alongwith other ICICI group companies, were operating as a virtual universal bank offering a wide range of financial products and services. In the

context of the move towards universal banking and the stiff competitive scenario in the Indian banking industry, both the entities were merged. The merged entity has now an access to low-cost deposits, higher income and participation in the payments system, entry into new business segments, higher market share in various segments especially in fee-based services and vast talent pool of ICICI and its subsidiaries which, in turn, would enhance the value for ICICI Bank shareholders. The merger has resulted in the integration of the retail finance operations of ICICI and its two merging subsidiaries and ICICI Bank into one entity, creating an optimal structure for the retail business. The share exchange ratio approved for the merger was one fully paid-up equity share of ICICI Bank for two fully paid-up equity shares of ICICI. The merger was approved by the shareholders of both companies in January 2002, by the High Court of Gujarat in March 2002, and by the High Court of Judicature at Mumbai and the Reserve Bank of India (RBI) in April 2002. ICIClcould successfully meet the statutory reserve requirements applicable to banks within the target date of March 30, 2002. While the merger became effective on May 3, 2002, in accordance with the provision of the Scheme of Amalgamation and the terms of approval of RBI, the appointed date for the merger was March 30, 2002. The merger created India's first universal bank and the second largest bank in the country with total assets of about Rs 1 trillion and about 540 branches and offices and over 1000 ATMs. ICICI Bank's equity shares are listed in India on stock exchanges at Chennai, Delhi, Kolkata, Mumbai, and the National Stock Exchange of India Limited.

ICICI Bank's American Depository Receipts (ADRs) are listed on the New York Stock Exchange (NYSE). It is the first commercial bank from India to list its stock on NYSE in 2000. ICICI has successfully transformed itself from a financial institution under indirect government control to a universal bank.

Subsidiaries and Affiliate Companies

Consequent to the merger of ICICI with ICICI Bank, ICICI's subsidiary companies have become subsidiaries of the bank. On March 31, 2002, ICICI Bank had eleven subsidiaries.

Principal subsidiaries

ICICI Securities and Finance Company Limited
ICICI Venture Funds Management Company Limited
ICICI Prudential Life Insurance Company Limited
ICICI Lombard General Insurance Company Limited
ICICI Home Finance Company Limited

Other subsidiaries

ICIC Brokerage Services Limited ICICI Securities Holdings Inc. ICICI Securities Inc.
ICICI International Limited
ICICI Investment Management Company Limited ICICI Trusteeship Services Limited

Affiliate companies

(i) ICICI Infotech Services Limited
(ii) ICICI Web Trade Limited (iii) ICICI One Source Limited

ICICI Securities and Finance Company Limited : The company was set up in 1993~94 to provide investment banking services. It addresses the critical financial requirements of companies, governments, and institutional investors, advising on corporate strategy, capital structure, and capital raising. It also acts as an advisor for mergers and amalgamations. It is a primary dealer in the government securities market. The company has one subsidiary in India, namely, ICICI Brokerage Services Limited and two subsidiaries in the US, namely, ICICI Securities Holdings Inc. and ICICI Securities Inc. ICICI Securities Holdings Inc. was incorporated in 2000-01 to provide investment banking services to the investors in the US who wish to enter the Indian financial market and Indian investors who wish to enter the financial market in the US. ICICI Securities Inc. was formed in 2000-01 to provide brokerage, research, and investment banking services to investors in the US who wish to invest in the Indian financial market.

ICICI Venture Funds Management Company Limited : The company was set up in 1988 and specialises in making equity investments spanning a company's business lifecyc1e from Venture Capital (VC) to Private Equity (PE) with an ultimate aim of generating superior financial returns for its investors. It is the equity investment arm of ICICI Bank. It not only provides funds for financing of new business ventures or expanding privately held business ventures but also provides business skills. It is the oldest and most successful firm in India in both VC and PE investing.

ICICI Prudential Life Insurance Company Limited: The company was incorporated on July 20, 2000, and commenced its operations in January 2001. The principal shareholders of the company are ICICI Limited (74%) and Prudential Corporation Holdings Limited (26%). The company's life insurance business comprises of non-linked participating, non-linked non-participating annuities and linked policies. It has emerged as a leading private life insurer in India in a short span of 15 months since it commenced its operations.

ICICI Lombard General Insurance Company Limited: The company commenced its commercial operations on August 31, 2001. The principal shareholders are ICICI Limited (74%) and Lombard Canada Limited (26%). The company received the license on August 3, 2001, from the Insurance Regulatory and Development Authority (IRDA) to undertake general insurance business.

ICICI Home Finance Company Limited: The company commenced its operations in 1999-2000. It provides home loans and other related services. It was the first housing finance provider to introduce floating rate loans. It has expanded into fee-based property services for both corporate and retail customers.

ICICI International Limited: This company was incorporated in the Republic of Mauritius on January 18, 1996, as an Investment and Fund Management Company.

ICICI Investment Management Company Limited : This is an asset management company of ICICI Securities Fund, a mutual fund registered with SEBI.

ICICI Trusteeship Services Limited : The company's role is to serve as a trustee for enterprises, transactions, or arrangements of strategic or significant business importance to the ICICI Bank group.

Organisation Structure of ICICI Bank :

The organisation structure is designed to support its business goals and is divided into five principal groups: I retail banking, wholesale banking, project finance and special assets management, international business, and corporate centre.
Retail Banking The retail business is the key driver of ICICI Bank's growth strategy. ICICI Bank is I today a retail financial supermarket, selling an entire range of credit, investment products, and various banking I services. ICICI Bank's retail portfolio (including the portfolio of ICICI Home Finance Company Limited, its wholly owned subsidiary) on March 31, 2002, was over Rs 76 billion as compared to the combined retail portfolio of ICICI and ICICI Bank of about Rs 29 billion on March 31, 2001. Its retail asset products include mortgages, automobile and two-wheeler loans, commercial vehicles and construction equipment financing, I consumer durable loans, personal loans, and credit cards. ICICI Bank emerged as a leading player in the mortgages business and consolidated its position as market leader in automobile loans during 2001-02.

Wholesale Banking Wholesale banking comprises corporate banking, treasury, structured finance, and credit portfolio management. ICICI Bank now focuses on working capital finance for highly rated clients, structured transactions, and channel financing. It offers structuring and advisory services for the public sector disinvestments process. It also offers transaction banking services such as cash management and non-fund I based facilities, including letters of credit and bank guarantees to increase market share in banking fees and commissions. The total volumes in cash management services have touched a new high of Rs 1.72 trillion during 2001-02. ICICI Bank provides internet banking services to its wholesale banking clients through ICICImarkets.com. The corporate banking business is organised into special relationship groups for the government and public sector, large corporates, emerging corporates, and agri business. ICICI Bank's Structured Products and Portfolio Management Group have access to expertise in financial structuring and related legal, accounting, and tax issues. This group actively supports business groups in designing financial products and solutions, and manages the asset portfolio by structuring portfolio buyouts and selldowns.

Treasury activities include management ofliquidity and exposure to market risks, mobilisation of resources from domestic and international financial institutions and banks, proprietary trading, and capital markets and custodial services operations.
Project Finance and Special Assets Management Project finance activities include financing new projects as well as capacity additions in the manufacturing sector and structured finance to the infrastructure and oil, gas, and petrochemicals sector. ICICI has developed considerable expertise in financing complex projects. Its role is not merely to provide finance but also to arrange and facilitate creation of appropriate financing structures that may serve as financing and investment vehicles for a wider range of market participants.

The Special Assets Management Group is responsible for large non-performing loans and accounts under watch.
International Business The International Business Group is responsible for ICICI Bank's international operations as well as coordinating the international strategies and alliances of its subsidiaries and affiliates.

Corporate Centre The Corporate Centre comprises all shared services and corporate functions, including finance and secretarial investor relations, risk management, legal, human resources, corporate branding, and communications. In 1998, ICICI introduced the new logo symbolising a common corporate identity for the ICICI group. .

ICICI also provides micro financial services to enable the poor to reduce their economic vulnerability and participate in the growth process. ICICI's Rural Micro Banking Group is engaged in delivering microfinance to self-help groups of rural women.

Financial Highlights of ICICI

(Rs in erore)

Year	*Sanctions*	*Growth Rate* (%)	*Disbursements*	*Growth rate* (%)
1991-92	4,094.9	9.4	2,351.3	19.5
1992-93	5,771.8	41.0	3,315.2	41.0
1993-94	8,491.4	47.1	4,413.3	33.1
1994-95	14,527.9	71.1	6,879.3	55.9
1995-96	14,594.9	0.5	7,120.4	3.5
1996-97	14,083.8	-3.5	11,180.9	57.0
1997-98	24,717.5	75.5	15,806.9	41.4
1998-99	32,370.6	31.0	19,225.1	21.6
1999-2000	42,522.8	34.5	25,835.7	34.4
2000-01	56,092.0	28.9	31,964.6	23.7
Cumulative upto				
end March 2001	2,47,558.5		1,46,167.2	

Source: IDBI, *Report on Development Banking in India, 2000-01.*

Income and Expenditure Account of ICICI

(Rs in crore)

	1999-2000	*2000-01*
A. Expenditure		
1. Payment of Interest	5,785.23	6,376.78
2. Other Expenditure	412.74	572.84
3. Depreciation on Assets Given on Lease	366.92	349.63
4. Provision for Interest Tax	112.00	-
5. Bad Debts Written Off and Provision		
for Restructured and Standard Assets	461.75	1,421.53
6. Provision for Taxation	122.00	40.00
7. Profit after Tax	1 ,205.75	537.27
Total	8,466.39	9,298.05
B. Income		
1. Interest on Loans	5,190.66	6,057.94
2. Income from Investments	1 ,206.70	1,162.66
3. Income from Leasing and Other Operations	1,720.07	1,615.57
4. Others/Profit on Sale of Investment and Other Income)	348.96	461.88

	8,466.39	9,298.05

Source: IDBI, *Report on Development Banking in India, 2000-01.*

Asset Classification (Net of Provisions)
(In percentage)

	AssetClassificaffon	1999-2000	20001
1.	Standard Assets	92.4	94.8
2.	Substandard Assets	3.4	1.5
3.	Doubtful Assets	4.2	3.7
	Total	100.0	100.0

Source: IDBI, Report on Development Banking in India, 2000-01.

Financial Ratios of ICICI

Financial Ratios	1996-97	1997-98	1998-99	1999-2000	200CHJ1
Profit After Tax to Average Net Worth (%)	20.5	24.3+	20.3	16.8	16.4-
Profit After Tax to Average Assets (%)	2.5	2.8+	2.1	2.1	2.1-
Earnings Per Share (Rs)	15.9	21.1+	18.2	14.0	17.0-
Book-value (Rs)	85.9	91.3	100.3	98.0	97.5
Average Cost of Funds (%)	11.8	11.6	12.1	12.1	11.7
Average Return on Funds (%)	15.3	14.9	14.6	13.9	13.5
Margin (%)	3.5	3.3	2.5	1.8	1.8
Debt-equity Ratio	6.0	5.7	5.7	4.1	4.7
Capital Adequacy Ratio (%)	13.2	12.9	12.5	17.3	14.7

* After adding accelerated provisions and write-ofts to profit after tax during the year.
+ Includes profit on sale of real asset.
Source: IDBI, Report on Development Banking in India, 2000-01.
Assistance sanctioned and disbursed by ICICI during 2000-01 increased by 28.9% and 23.7%, respectively Assistance outstanding amounting to Rs 63,786.9 crore as on March 31, 2001 grew by 16.9% as compared to a growth of 15.9% in 1999-2000. Sanctions increased in respect of industries such as infrastructure, metal products, paper and paper products, electronic equipment, cement, services, crude petroleum and petroleum refining and chemicals and chemical products. Purpose-wise assistance sanctioned and disbursed by ICICI indicated a clear shift towards financing of new projects, working capital margin loans, corporate loans and retail finance. Expansion/diversification projects and rehabilitation projects recorded a decline.

A slowdown in the industrial activities affected the total income and profits of ICICI. Profit after tax (PAT) declined by 55.4% during 2000-01 due to higher bad-debts write-offs and provisions. The net NPAs declined to 5.2% as at end-March 200 1 from 7.6% as at end-March 2000 due to accelerated provisions. Total assets increased

by 12.3% in 2000-01. Capital adequacy ratio was lower at 14.7% in March 2001 partly due to growth in assets.

The merger of ICICI and its two subsidiaries with ICICI Bank took place in March 2002. The pre-merger profits of ICICI Limited before additional provision for tax was Rs 1,332 crore for the year 2002 as compared to Rs 1,390 crore for the year 2001. The profit after additional provisions and tax increased by 25% to Rs 670 crore for the year 2002 from Rs 537 crore for the year 2001. The ratio of net non-performing assets to net customer assets of the merged entity was 4.7% on March 31, 2002.

Conclusion

ICICI is India's best-managed financial institution, catering to the needs of different customers. It has successfully transformed itself from a single product company to a multi-group financial services group. The merger of ICICI and its two subsidiaries with ICICI Bank has led to the creation of the largest private sector bank in the country with a highly diversified asset base. ICICI has geared itself to compete effectively in the competitive world of commercial banking.

STATE INDUSTRIAL DEVELOPMENT CORPORATIONS

The State Industrial Development Corporations (SIDCs) were established under the Companies Act, 1956, as wholly owned undertakings of the state governments. They act as catalysts for the promotion and development of medium and large enterprises in their respective states/union territories. They act as nodal agencies of state governments for promotion of industrial growth and development of infrastructure facilities.

There are 28 SIDCs in the country. Of the 28 SIDCs, 11 also function as State Financial Corporations (SFCs) to provide assistance and act as promotional agencies for small and medium enterprises. These are in Andaman and Nicobar, Arunachal Pradesh, Daman and Diu and Dadra and Nagar Haveli, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Goa, Pondicherry, and Sikkim.

SIDCs encourage setting up of projects in the joint/assisted sector in collaboration with private entrepreneurs. The competition among states to attract fresh investment has increased. SIDCs have undertaken the role of marketing their states as favourable investment destinations. To attract investment, SIDCs provide. tax benefits under the state government's package scheme of incentives. SIDCs undertake a variety of promotional activities such as preparation of feasibility reports, conducting industrial potential surveys, entrepreneurship training and development programmes, and developing industrial areas/estates. Some SIDCs also offer a package of developmental services that include technical guidance, assistance in plant location and coordination with other agencies. SIDCs are also conduits of IDBI/SIDBI for operating their seed capital schemes. With a view to keeping pace with the changing environment, many SIDCs have diversified into new fee-based services and widened the scope of fund-based activities.

SIDCs extend financial assistance in the form of rupee loans, underwriting and direct subscription to shares/debentures, guarantees, inter-corporate deposits and also open letter of credit on behalf of their borrowers.
SIDCs raise resources through refinance from IDBI/SIDBI, the government, and banks. They can also borrow funds by way of issue of bonds/debentures. They also receive subsidies/incentives from government for disbursements. SIDCs accept deposits to meet their fund requirements. SIDCs come under the purview of the

Department of Company Affairs.
During 2000--01, financial assistance sanctioned and disbursed by SIDCs increased by 29.9% and 3.1% respectively, as against a decline in sanctions and disbursements of 29.8% and 25.8% in 1999-2000 respectively.
Direct finance constitutes a major proportion of overall sanctions. The share of project finance constitutes more than 50% of the total direct finance. Most of the SIDCs have poor asset quality, which has affected their financial health.
Conclusion
The SIDCs act as catalysts for the promotion and development of medium and large enterprises in their respective states. They have a major development banking role to perform in the states. With pressures and challenges of economic liberalisation, they have not only to grow but they have to maintain their financial health. They need to undertake a market-oriented approach without forgetting their developmental role.

STATE FINANCIAL CORPORATIONS
Following the enactment of the State Financial Corporations Act in 1951, State Financial Corporations (SFCs) were established in various states. They meet the financial requirements of small and medium enterprises. Presently there are 18 SFCs operating in their respective states or union territories, of which 17 were set up under the SFCs Act, 1951. Even before the SFCs Act came into force on August 1, 1952, the Madras Industrial Corporation was already set up in 1949 under the Companies Act. It was later renamed as Tamil Nadu Industrial Investment Corporation Limited which now functions as a State Financial Corporation (SFC). Punjab Financial Corporation was the first SFC to come into existence in February 1953, followed by SFCs in Mumbai, Kerala and West Bengal. A separate SFC for Gujarat was set up in May 1960 through bifurcation of the Bombay SFC. The SFCs in Delhi, Haryana and Himachal Pradesh were carved out of Punjab Financial Corporation in 1968.

Under the provisions of the SFCs Act, SFCs are authorised to raise resources by issue of capital, issue bonds and debentures guaranteed by the state governments, accept medium- and long-term deposits from the public, and borrow from other financial institutions. A majority of fund mobilisation by SFCs is through refinance from SIDBI and IDBI
The SFCs provide financial assistance by way of term loans, direct subscription to equity/debentures, guaranteeing loans/deferred payments of industrial concerns, discounting of bills of exchange and seed! special capital. The SFCs operate a number of schemes of refinance and equity-type assistance on behalf of IDBI/SIDBL The operational policies of SFCs have been geared to assist artisans, tiny village and small industries, develop backward regions and promote new entrepreneurs. SFCs operate

special schemes for special target groups such as SC/ST, women, ex-servicemen, and physically handicapped.

The SFCs (Amendment Act, 2000), which became effective in September 2000, provides greater flexibility to the SFCs to cope with the challenges of economic liberalisation strongly impacting the financial sector. All the 18 SFCs come under the purview of Small Industries Development Bank of India (SIDBI). SIDBI has not stipulated any capital adequacy requirement or prudential norms for SFCs.

Financial Highlights of SFCs

Assistance Sanctioned and Disbursed by SFCs

(Rs in crore)

Year	Sanctions	Growth rate	Disbursements	Growth rate
1990-91	186.39	23.1	1 ,270.8	9.9
1991-92	2,190.3	17.5	1,536.8	20.9
1992-93	2,015.3	-8.00	1,557.4	1.3
1993-94	1,908.8	-5.3	1 ,563.4	0.4
1994-95	2,702.4	41.6	1,880.9	20.3
1995-96	4,188.5	55.00	2,961.1	57.4
1996-97	3,544.8	-15.4	2,782.7	-6.0
1997-98	2,626.1	-25.9	2,110.2	-24.2
1998-99	1 ,864.2	-29.0	1,624.7	-23.0
1999-2000	2,237.8	20.0	1 ,825.1	12.3
2000-01	2,790.0	24.7	2,005.1	9.9
Cumulative upto				
end March 2001	35,888.7		29,284.3	

Source: IDBI, Report on Development Banking in India, 2000-01.

Assistance sanctioned and disbursed by SFCs have registered an increase in the last two years, namely, 1999-2000 and 2000-01. During 2000-01, out of 18 SFCs, 11 SFCs recorded an increase in sanctions. In terms of absolute sanctions, the top 5 SFCs were those in Karnataka, Andhra Pradesh, Kerala, Gujarat, and Tamil Nadu.

SFCs sanctioned assistance to industries such as food products, chemicals, textiles, services and other industries. Sanctions to small scale sector comprising Small Scale Industries (SSIs) and Small Road Transport Operators (SRTOs) increased. New projects accounted for majority of total assistance sanctioned following by expansion/diversification.

Conclusion

SFCs are facing stiff competition from commercial banks and other state level institutions. They need to restructure themselves to face this competition. The Government of India has set up a Committee headed by Shri G P Gupta, the ex-Chairman and Managing Director, Industrial Development Bank of India, for looking into the functioning of SFCs and making recommendations for their restructuring and revitalisation. As per the Gupta Committee Report, the net worth of 11 SFCs was negative. The capital adequacy ratio of 12 SFCs was negative while it was below 9% in case of three SFCs. The Gupta Committee estimated that Rs 2,04,468 crore is

required for NPA provisioning for all the 18 NPAs. The recommendations are under consideration of the Central Government. For survival and growth, SFCs have to carve out a niche for themselves by specialising in financing and development of SSI sector.

ASSET-LIABILITY MANAGEMENT IN DEVELOPMENT FINANCIAL INSTITUTIONS : THE TASKS AHEAD

Divided into four sections, this paper begins with an exploration of the historical trends in business and funding pattern of development financial institutions that have an important bearing on risk incidence; describes the recent changes in risk profile of these institutions in the next section; reviews asset-liability management guidelines issued by RBI in the third; and in the concluding section, highlights opportunities and challenges faced by DFIs in management of market risks in a competitive and globalize market environment.

Broadly defined, asset-liability management is financial intermediation that includes activities of institutions that seek to maximize their net interest income and reduce volatility therein. It is, therefore, a process of planning to direct and control structure of assets and liabilities in terms of their level, currency composition, cost/ yield and maturity pattern. These activities are crucially important for the business and profitability of each financial intermediary. All lending institutions, of course, face credit risk : the risk of default.

Incidence of credit risk is important. It needs to be measured, monitored, and managed. Asset-liability management is generally associated with identification, measurement, and monitoring of risks other than credit risk. These are also called market risks and signify interest rate, foreign exchange risk, and liquidity risk. While it is analytically important to identify market risks as distinct from credit risk, it is necessary that banks and financial institutions adopt an integrated view of risk management.

Asset-liability management is getting focused attention only now because of the deregulation of financial markets. Even on a global scale, foreign exchange rates were freed only in the1970s. Control on movement of capital was present even in several developed countries till mid 1985 (in some countries up to the early 1990s). A shift from asset management to liability management became noticeable. It is now making way for an integrated view of assets and liabilities. Asset-liability management thus gains importance as market risks such as interest rate risk, and foreign exchange risk becomes important as markets are liberated and integrated.

As part of the economic reform program initiated since June 1991, several measures were introduced to deregulate the financial sector in India. The reforms program facilitated development of the capital market both in equity and debentures, modernization of stock exchanges by introduction of modern technology, and increased competition between different participants in the financial sector. As part of its efforts to enable different constituents of the financial sector face challenges

confronted by competitive financial system, RBI introduced guidelines on asset-liability management for commercial banks and development financial institutions.

The main purpose of the guidelines is to "sensitize the management of financial institutions to the need for a formally structured management of the liquidity and interest rate risk of their portfolios" as also to enforce the discipline of risk management (the need to identify and assess the risks before these are taken on books). While the guidelines issued for DFIs are yet to be finalized, it will be instructive to assess the challenges these institutions will face in management of market risks (which is slated to increase as commodity and financial markets in India become competitive and get integrated with world markets).

Section I: Business and funding patterns

Development financial institutions were established to support establishment of industrial projects in the absence of well-developed capital markets, which could provide long-term funds for such projects. Commercial banks were funding working capital requirements and perhaps unwilling to undertake the risk associated with project financing. As a result, a network of financial institutions was established in the post-independence period to provide long term-loans to industrial projects of different size and category. State-level institutions catered to the needs of small and medium industrial units, while all-India financial Institutions such as IDBI, ICICI & IFCI funded large-scale projects on a consortium basis.

In several cases, equity support came from the government or RBI. RBI also provided long-term loans. Lines of credit from multilateral lending agencies were made available to development financial institutions, which had government guarantee. Government also provided guarantee to bonds floated by these organizations for a longer duration at a relatively low cost. Such bonds were eligible securities for statutory liquidity ratio to be maintained by commercial banks and also treated as approved investment for insurance companies. As bulk of the funds were lent directly or indirectly by the government, the cost of funds was controlled by the government and had an element of concession in it. Government, in turn stipulated a lending rate for these institutions to ensure that funds are lent to industrial projects at reasonable rates of interest.

From the business perspective of development financial institutions, these arrangements represented a situation where each institution has guaranteed business and profits. Each institution had access to an exclusive niche market. This was a result of the market sharing arrangement prevalent among different lending institutions. Secondly, as the lending and borrowing rates were fixed by the government, profit margin for these institutions was also ensured in the process. In such an environment, there was very little scope for competition among different institutions.

From the risk perspective, stipulation of lending rates for different categories of borrowers meant that it was not possible for the financial institutions to charge a risk-related interest rate. In fact, concession rates of interest were stipulated for projects located in backward areas, projects promoted by new entrepreneurs and projects in the small-scale industries segment. It may be conceded that all these categories of projects would represent higher than average risk class but the rates charged on such loans were lower than the normal rates. The rates stipulated by the government were

lower than similarly stipulated rates of interest on working capital loans provided by commercial banks. Again, from the risk perspective, rates on long-term loans should have been higher than rates on shorter-term loans, as long-term would signify higher risk.

The government, however, stipulated a lower rate on term loans with a view to promote fixed capital expenditure. Thus, on the risk perspective the business and operating environment faced by banks and financial institutions was such that there was little scope to undertake risk analysis covering its various dimensions - credit risk, interest rate risk, liquidity risk and foreign exchange risk. This is illustrated below in the context of development financial institutions:

Credit Risk: While credit risk is basic to all lending institution under a licensing regime, allocation of credit depended on procurement of industrial licensing by the borrower. The licensing decision taken by government implicitly decided most, if not all, parameters of credit risk that development financial institutions would take on their books. The industrial licensing would determine production, scale, technology, location of the plant, and also the borrower client itself. In the context of import substitution strategy of industrialization followed in India, high import duty rates and control of fresh capacity creation through licensing mechanism ensured market and profitability for domestic industries. This indirectly took care of several problems associated with credit risk. Its hardly surprising that the need for an explicit analysis of credit risk or to make efforts to manage it was felt.

Interest rate risk: Interest rate risk arises when impact of changes in interest rates is asymmetric in the sense that this impact is not uniform on assets and liabilities. This could happen if maturities of assets and liabilities are different and interest rates differ according to maturity. Secondly, the interest rates on lending and borrowing may show different trends. However, as both lending rates and borrowing rates faced by development financial institutions were controlled by the government, these were indirectly protected from interest rate risk as well.

Liquidity risk: Liquidity risk arises when a financial institution is unable to meet its obligations to a client or borrower on the due date. Liquidity risk can be minimized by maintaining a balance between maturing assets and liabilities. This aspect was indirectly taken care of as resource support from governmental sources, besides being at concession rates, was also for a longer term – typically for a period of 15-20 years. As financial institutions normally gave loans for a period of 8-10 years, it was possible for them to recycle these funds two or three times before which borrowing became due for repayment. The maturity differential thus ensured that development financial institutions would generally not face a liquidity problem.

Foreign exchange risk: Foreign exchange risk is another important dimension of market risk that development financial institutions would face as foreign exchange markets are deregulated. Financial institutions have been extending foreign currency loans even in the past. They have mobilized funds from multilateral lending agencies such as The World Bank and Asian Development Bank and also raised funds through external commercial borrowings. However, in the case of several multilateral loans, the Government of India has borne the foreign exchange risk. Financial institutions have not assumed any foreign exchange risk even on funds raised through other

sources. Foreign currency loans were given in the same currency and loan repayment profile was exactly matching with the debt repayment schedule an institution is required to follow. In the process, clients would at times have to face a loan repayment schedule not synchronized with cash flows from assisted projects. This difficulty is mitigated by creation of a single currency pool wherein funds borrowed in particular currency will be pooled together and loans from this pool would be extended to clients on the basis of repayment schedule, which is consistent with projected cash flows. It, however, needs to be noticed that even under this arrangement the lending institution is not assuming any foreign currency risk. Such a risk arises only if currency composition of loans is different from currency composition of its borrowing.

It thus becomes clear that historically development financial institutions' exposure to market risks was almost zero. As regards maturity pattern of assets and liabilities, assets had shorter maturity period as compared to maturity period of liabilities. This situation ensured that development financial institutions would be shielded from incidence of liquidity risk as well. Under the industrial licensing system and policy to protect domestic industries had a significant effect on even the credit risk profile faced by the development financial institutions.

Section II: Changing risk profile

With the introduction of economic reforms, credit and non-credit risks faced by development financial institutions underwent metamorphic changes, which has effected both the real sectors as well as financial sectors. It has had a significant impact on the business opportunities and funding pattern of development financial institutions. Firstly, with a view to reduce its fiscal deficit, the central government has phased out resource support it traditionally extended to development financial institutions. The loans out of RBI's National Industrial Credit (long-term operations) fund were suspended and are now available only to Small Industrial Development Bank of India (SIDBI). The quota of government guaranteed bonds (commonly known as SLR Bonds) has been completely phased out.

As a result, development financial institutions are required to meet their resource requirements by raising funds from capital market on market-related terms and conditions. In general, a shift to market based funding has resulted in an increase in the cost of funds and also a decrease in the average maturity thereof. The decline in maturity is the outcome of reluctance on part of investors to block their funds for longer duration. When future interest rates are more uncertain, higher is the maturity period. Moreover, for longer maturities, higher compensation would be necessary to induce the investors to bear the increased risk associated with long-term investment. The institutions, thus, are faced with a trade off between liquidity risk and higher profitability.

As long as interest rates were regulated, institutions did not face any interest rate risk. However, with progressive liberalization, interest rates are likely to move both ways (go up or go down). While it is true that the same process of interest rate liberalization has also allowed development financial institutions to charge a risk related interest rate on their loans, their exposure to interest rate risk has definitely increased in the process. The process of liberalization has also resulted in more competition between

different segments of the financial system as also among different entities within a segment. Commercial banks are now extending term loans while development financial institutions are diversifying into non-project lending by offering short-term products including working capital loans.

Capital markets have grown phenomenally since early 1980s and have emerged as important source of funds for corporate sector in general and blue chip companies in particular. Moreover, liberalization of controls on foreign exchange transaction and facilities offered for foreign investors to invest in India and also for Indian companies to raise funds from overseas markets has widened the funding menu of the Indian corporate sector. It is now possible for a profit making company to have a wider choice of avenues to raise funds to fund its capital expenditure plans.

In such a situation, lending organizations have to compete among themselves as also with capital market itself while offering corporate finance products. The competition takes a form of price competition, by way of lower interest cost and it also touches non-price dimensions. The range of products offered by organizations, the ability to respond quickly to the needs of the corporate sector and offer a wider range of products that meet client requirements becomes extremely important. This situation is under sharp contrast in relation to pre-reform period where development financial institutions had almost an assured market and profit margin.

The process of competition has forced development financial institutions to offer a wider range of products. While several institutions have added shorter term lending products, intense competition from capital markets and banks have made it necessary to adopt a flexible approach. Under such circumstances, every deal is a uniquely structured deal with a view to improve the level of client satisfaction. Thus the rate of interest, the repayment profile of the loan, security offered, currency offered, in effect each and every aspect of the lending product, becomes negotiable. It would be possible to compete to meet client needs on the basis of each of these factors.

It, therefore, becomes essential that lending institutions are able to raise funds that are suitable to meet the client requirements as also protect profit margins in a competitive marketplace. In such a competitive marketplace, clients would tend to shop around to get the best possible terms for their requirement. For example, clients may get a loan sanctioned but may not use the facility if they find another cost effective alternative source of funding. Or, they may, in turn, decide to use the sanctioned facility depending on the anticipated changes in interest rate environment. In such a situation, managing liquidity risk becomes more challenging.

Till now financial institutions have not assumed direct foreign exchange risk. However, as and when the Indian Rupee becomes convertible on capital account, financial institutions and corporate would have wider options regarding fund-raising. They could borrow in different currencies after taking into account combined cost of interest rate and anticipated changes in the exchange rate. In such a situation, it would be essential to have a mechanism by which foreign exchange risks are measured and monitored on a regular basis. It thus becomes clear that the level of market risk faced by development financial institutions has increased significantly.

In recent years financial institutions, on their part, have responded to these challenges by offering different products for their borrowers and lenders. For example, floating rate products enable a financial institution to limit its exposure to interest rate risk. As a result of the shift to market based funding, financial institutions were finding it difficult to raise funds for longer duration. In response, financial institutions have tried to reduce the average maturity on their lending by offering short-term, non-project finance products. Similarly, exposure to foreign exchange risk can be hedged naturally by extending such loans to exporters whose income is denominated in foreign currencies.

In developed capital markets, different types of risk are hedged through derivative products. For example, interest rate risk can be managed through interest rate swaps. Similarly, foreign exchange risk can be hedged through currency swaps. The use of derivative is the off balance sheet way of managing market risk. Use of such derivative products in India will depend on development of such products, which, in turn, is linked to development of the secondary debt market. Till such time these markets develop, banks and institutions would need to manage different types of market risks through acquisition of incremental assets and liabilities of appropriate maturity/interest rate/currency.

Section III: The need for asset-liability management

The need for asset-liability management was formally stressed by RBI through the draft guidelines it issued first for commercial banks in September 1998 and subsequently for development financial institutions in April 1999. Both sets of guidelines are quite similar and would help banks and financial institutions adopt a comprehensive asset-liability management view of activities: information system, organization, and process.

The guidelines stress the need to put in place the management information system that would capture information on such aspects of assets and liabilities that are relevant for measurement of market risks. These would include remaining maturity of debt/loan, interest rate, interest-reset dates if interest rate is floating, interest and installment payment dates, etc. Data needs to be collected accurately and in a timely manner. The guidelines also recommend an Asset Liability Committee organization pattern and delineate the responsibilities of the board (set risk philosophies and tolerance limits for different types of risks), the committee (monitor risk limits and formulate business strategy), and support group (gather the information and prepare papers for discussion at committee level).

The asset-liability management process comprises risk identification, risk measurement, setting tolerance limits, and risk management. The guidelines are focused primarily on liquidity and interest risks. The guidelines prescribe generation of gap reports for measurements of liquidity risk (liquidity gap report) and interest rate risk (interest rate gap) in the prescribed formats. The report covers all assets and liabilities covering on and off balance sheet items. The guidelines aim to make these reports very comprehensive.

It prescribed 10 time buckets, which cover periods over 10 years. It not only covers items already on balance sheet but would also include assets, which would be created in future through un-disbursed loan commitments. For the sake of completeness, it becomes imperative to take into account the future inflows (by way of interest and installment receipts) arising from such future loan disbursements. One wonders whether by focusing on completeness, these guidelines miss the immediate relevance of the report.

While it is true that suggested risk measures– liquidity gap and interest rate gap– are very preliminary, these have been presumably chosen because this is indeed the initial stage of practicing asset-liability management. Moreover, given the predominance of loans on portfolios of development financial institutions and the current state of secondary debt market (particularly non-government paper), the usage of sophisticated tools of risk measurement would indeed be limited. However, certain observations could nevertheless be offered with a view to improving the significance of such guidelines:

The buckets: The guidelines suggest a total of ten time buckets, which would cover full maturity period of asset/liability. Of which, the first two time buckets are of 14-day duration each, the next time buckets are 29 days to three months, 3-6 months, 6 months to 1 year, 1-3 years, 3-5 years etc. The last time bucket is over 10 years and above. The first two time buckets are, perhaps, linked with the reporting frequency for commercial banks. The same time buckets are prescribed even for development financial institutions partly because these are slowly entering into businesses that were traditionally identified with commercial banking. In addition, RBI would get data on liquidity, which can be easily aggregated only if the formats are similar. However, the inflows and outflows of development financial institutions are quite discreet: these have specific maturity dates unlike bank assets (cash credit) and liabilities (savings or demand deposits). Hence, to account for uneven inflow/outflow patterns, the negative gap limit could have been prescribed for a wider time bucket (say up to three months).

Gap limit: For the liquidity gap report, the guidelines prescribe a negative gap limit of 5% of the projected outflows in the first two time buckets i.e. 1-14 days and 15-18 days. It is also stipulated that cumulative gap up to 1 year should not exceed 10% of the projected outflows. For commercial banks, this limit has been set at 20%. The logic for lower limit for development financial institutions is perhaps due to their inability to raise short-term funds at short notice. Liquidity risk needs to be kept at a minimum level with which the management is comfortable. RBI could have asked development financial institutions (and banks) to set acceptable limits depending on their risk appetite and preferences. Instead, the guidelines prescribe a uniform limit for all development financial institutions. Moreover, the negative gap limit could have been linked to borrowing capacity of the organization (say to level of debt-equity ratio), which would have remained stable. Instead, the guidelines link it to the outflows during the relevant time bucket, which would fluctuate from fortnight to fortnight depending on anticipated outflow of funds. RBI is perhaps also looking at this exercise from systemic liquidity and it has set a limit only for negative gap.

However, from business profitability as also interest rate perspective, even positive gap should be subject to prudential limits. The anticipated inflows need to be recorded in a particular, prescribed manner. For standard loans, the inflows are to be bucketed based on the due dates of payments. For sub-substandard assets, the guidelines suggest an elongated time pattern. But when the time buckets are as short as a fortnight, the receipts could be delayed (up to 6 months) without change in asset classification but the anticipated inflows and gaps would be affected. While it is true that as long as funds are received regularly, the levels of inflows would not be significantly affected.

However, over short intervals it could make substantial difference. Similarly, instead of a prescribing fixed formula to treat receipts from non-performing assets, the lending institution could have been allowed to bucket these payments based on the realistic payment dates, which would be case specific.
It is indeed surprising that neither any gap limit nor a threshold level for non-institutional investors is stipulated for interest rate sensitivity report. While it could be argued that RBI has left these matters to the discretion of respective bank/development financial institution management, by the same logic even the task of setting up liquidity gap limit could have been left at their discretion. It could be argued that by asking bank/development financial institution management to set tolerable risk limits of their choice and ensuring strict adherence to such limits, would have helped in creating risk management awareness among them.

Section IV: Challenges and opportunities
The draft asset-liability management guidelines definitely mark a useful starting point. The guidelines raise certain pertinent issues about the need for an effective management information system. This is closely related to level of computerization in an organization. There are quite obvious hardware and software issues linked to design an information system to generate consolidated reports in a timely manner to be used by asset-liability committees. There are, however, several other important issues that need to be effectively addressed for propagation of asset-liability management. Some of which include:

Risk Limits: At this initial stage of introducing asset-liability management, RBI has prescribed a limit on negative gap. However, it is likely that in course of time acceptable level of risk would be decided by managements themselves even if these were not made public. Certain reports about gaps, duration or value at risk would be made available to the public but the level of acceptable risk would need to be decided by individual organizations. Such tolerable limits could change over time and in response to market volatility, etc. In fact, in these matters institution's view on future market movement would be equally relevant. For example, when interest rates are expected to go up, higher positive gaps could be targeted and when rates are expected to go down, lower positive gaps or negative gaps would be targeted. It would be necessary for development financial institutions to help generate a truly institutional view, which would guide the activities of the organization.

Risk management and business strategy: Once the risk measures and tolerance levels are decided, the next task is to manage the risk with the set norms. This could be done

through on balance sheet as also off balance sheet methods. The former tries to choose incremental assets and liabilities with preferred characteristics so that overall risk is kept at desired levels. The latter makes use of derivative products like interest rate/currency swaps. The use of derivative product would depend on market development. But market would, in turn, develop on asset-liability structures of different institutions and the proactive approach adopted by market participants. Even if development financial institutions are to adopt on balance sheet methods, the imbalances would enable them to offer derivative product to their clients which besides meeting client needs helps balance the asset liability structure. For example, anticipated negative gaps say one year ahead could create an opportunity to offer short-term loans. Or if an organization has floating rate liabilities and fixed rate assets, it could offer fixed to floating rate swaps to its clients.

Reorganizing credit decision process: Once it is accepted that interest rate and liquidity risks are quite distinct from credit risk which normally gets assessed in credit sanction and monitoring process, setting interest rate on a loan and term for which it is extended are considered from profitability and/or client needs perspective. Such decisions are made on a case-to-case basis. Whereas from liquidity risk or interest rate risk management perspective it is desirable to adopt a portfolio approach, it is true that even credit risk management dictates to adopt a portfolio approach. But this requires that existing credit decision process is modified to accommodate the factors dictated by asset-liability management considerations. The issue is to ensure that the regularly generated asset-liability management reports become integral parts of credit decision process and do not remain new but independent activities. All this would necessitate different functionaries are taking independent stance and undertake business activities which are linked to that stance. The asset-liability management processes would facilitate setting up limits and periodically revising them. But ultimately identification of job responsibilities, performance measurement and follow up and possibly providing a link between performance and pay would be required to empower employees to assume business risk.

In the past, risks were simple and limited. Government ownership of most of the banks and development financial institutions and a market sharing arrangement that prevailed till recently, helped to have similar risk preference and policies across organizations. It would be difficult to have similar arrangements in future as risks are increasing and competition is becoming more intense. It is quite common that any analysis of risk management is usually focused on probabilities (of risk) and prices (necessary to buy risk cover). The discussion centers on what is the probability of risk and the proper price to pay for hedging that risk. However, risk preference is an equally important parameter, which also needs as much attention.

It would thus become necessary for development financial institutions to evolve a distinct risk preference (including risk aversion). To achieve this would be a crucial task of organizational restructuring. While problems associated with information gathering, information processing, devising an appropriate risk measurement tool, among others, is certainly important but the true challenge is to facilitate necessary organizational changes, which would facilitate dealing with risk in a mature

professional manner. Unless this is achieved, asset-liability management may remain an isolated peripheral exercise.

REBUILDING OF INDIAN DEVELOPMENT FINANCIAL INSTITUTIONS

INTRODUCTION:

Special industrial financing institutions were set up during the post-World War II period in both developed and underdeveloped countries with the specific purpose of providing long term funds to new industrial enterprises. Their tale was, however, more pronounced in the developing countries as in these countries the government had taken upon themselves the responsibility of mobilising resources for much desired industrialisation.

These special industrial financing institutions do not compete with other agencies of industrial finance as they are assigned the role of "gap fillers". Since these institutions operate with a special purpose (and an instrument of State policy) they make significant contribution to the process of industrial development. They are also recognized as "Development Banks" or "term lending institutions" or "specialised development financial institution".
There are a number of Development Financial Institutions that were set up in India during the planning era. Let us now turn to a discussion of the main industrial finance institutions operating in India.

ROLE OF DEVELOPMENT FINANCIAL INSTITUTIONS

1. Providing Finance: The DFIs provide medium term and long term finance to industry. Since 1997, some of the DFIs have also started to provide working capital requirements to large industries.

The long-term loans are provided for the purpose of setting up new projects, for expansion and modernisation, for mergers, etc.

2. Guarantee of Loans: The DFIs provide guarantee of loans raised by industrial concerns in India, provided by commercial banks, cooperative banks, and others.

3 Project Promotion: The DFIs facilitate project promotion. They have set up project promotion departments. The project promotion involves:

- Making available information on specific products or processes and relevant economic data to entrepreneurs
- Prepares project reports
- Conducts industrial potential surveys
- Assisting state-level financial institutions like SFCs in their training and development program.

4 Refinancing: The DFIs like SIDBI, IDBI, etc undertake refinancing functions. They refinance the commercial banks and others who have earlier provided loans to the industrial concerns.

5 Revival of Sick Units: The DFIs work out a financial package to revive potentially viable sick units. The package includes:

- Injecting more funds

- Rescheduling of principal and interest payments
- Writing off a part of interest and loan
- Appointment of DFIs on the Board.

We shall now discuss the 3 major DFIs in India and critically examine their progress over the years.

INDUSTRIAL FINANCE CORPORATION OF INDIA.

Soon after independence, the Government felt a need to cover the institutional gap in the capital market to provide medium and long-term credit to the industry. IFCI was the first Development Financial Institution (DFI) set up by the Government in 1948, under the IFCI Act.

It grants financial assistance in the following forms:

- Granting loans or advances both in rupees and foreign currencies repayable within 25 years
- Guaranteeing rupee loans floated in the open market by industrial concerns
- Underwriting of shares and debentures of the industrial concerns
- Providing merchant banking services and lease finance

Critical Appraisal

Opinions differ sharply in respect of the IFCI's working over the past decade. Some of the criticisms are:

- The IFCI lending operations have encouraged concentration of wealth and capital.
- The IFCI has done little to remove regional disparities in the country.
- The IFCI has not also upheld the national priorities is respect of financial assistance as stated in the plan documents
- The IFCI has quite often offered assistance to undertakings which could easily raise resources from the capital market
- The IFCI has failed to exercise necessary control over the defaulting borrower.

THE INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA LTD.

The Industrial Credit and Investment Corporation of Indian Ltd (ICICI) was the second all India DFIs to be established in the country. It was set up in January 1995 and it commenced business in March the same year. Unlike IDBI and IFCI, ICICI is a private sector development bank. It provides assistance in the various forms, like

- Long or medium term loans or equity participation
- Guaranteeing loans from other private investment sources
- Subscription to ordinary or preference capital and underwriting of new issues of securities
- Rendering consultancy service to Indian industry in the form of managerial and technical advice.

Critical Appraisal

The ICICI in the 4 and half decades of its existence has played and important role in providing assistance to industrial enterprises in India. Its pioneer work in underwriting has been widely acclaimed. However, it has been criticized for assisting mainly the large units. It has not done much to remove regional disparities and has not

funded for the growth of backward areas. Due to the increase competition in the financial markets and fund based business getting affected by lower margins and higher level of NPAs, the company is trying to get a major share in the retail segment where the margins are better. This has been made possible through the various subsidiaries, which the company has floated, and through expansion of the distribution network

THE INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)

Post second 5-Year plan, need for an apex institution to coordinate workings of other financial institutions and help in the country's industrial development was felt. Therefore, IDBI was established in 1964 as a wholly owned subsidiary of the Reserve Bank of India. In the initial years IDBI received RBI's financial support and experience. In 1976, the Government of India de-linked IDBI from RBI and assumed its total ownership by an Act of Parliament. The international finance division was hived off from IDBI in 1982 as a new company EXIM Bank. In 1992, IDBI's portfolio relating to small-scale industrial sector was transferred to Small Industrial Development Bank of India (SIDBI), set up as IDBI's wholly owned subsidiary.

Critical Appraisal

The IDBI was set up more than 3 decades ago to function as an apex institution in the field of development finance. Judged by its assistance measured in quantitative terms, its performance is very impressive. However, the IDBI has failed to develop itself as a true development bank. It has failed in developing the capital markets. Its distribution of financial assistance is also not very healthy, as the largest chunk has gone to big industrial concerns. The IDBI also did not concentrate itself on providing promotional and consultancy work. Thus there is need for a change in the approach of the IDBI towards industrial development.

Financial Analysis:

We shall analyze the current financial position of the DFIs and throw light on the different problems and impediments, which have wrecked these institutions and it, could wreck the entire financial system. We have to ascertain whether these DFIs are actually doing what they were set up for?

If we take a look at the IFCI, the net Non-Performing Assets (NPAs) amounted to Rs 41026mn in FY2000 and comprised of 20.7% of the total net assets of 198.4bn. The IFCI is close to bankruptcy. In 1999-2000, the IFCI had an income of Rs 2,899.7 crore and earned a net profit of Rs 59.3 crore. Next year, on an income of Rs 2,890.3 crore, the institution showed a loss of Rs 265 crore.

Meanwhile the IDBI's net NPAs to total assets rose to 14% from 12% in last year. One out of every seven rupees lent out by IDBI to companies may not be paid unless the NPA problem is sorted out in quick time. The concern for the bank on its NPAs stems from the high exposure levels to the Iron & Steel and the cotton textiles industry, which together contributed to 23.5% to its total NPAs as on year end 1999-2000. It is today asking the government for a bailout.

ICICI has transformed itself from the role of a FI to a Universal bank. The company is making constant efforts to take first mover advantage in the technology-related businesses. The net profit of the company reduced by 55% in FY2001 to Rs5372.7mn

from Rs.12057.5mn in FY2000. Mainly due to heavy provision made to cover the NPL (Non performing loans). The net NPA ratio has fallen from 7.6% to 5.2%. Gross Non-performing loans has reduced to Rs59.88bn in FY2001 from Rs60.18bn in FY2000

From the above analysis it is quite evident that high NPA level is a core problem for the DFIs. There are many reasons that contribute to NPAs. They can be broadly classified as Macro-Economic factors and Micro-Economic Factors.

Macro-Economic Factors:
These are factors that affect the economy as a whole. After the opening of the Indian economy, several Indian companies, were suddenly pitted against international players with a strong financial and technological muscle. The license era of pre-liberalization days attempted to ensure a match between the supply and demand situations in the economy. Thus if you were granted a license the system implicitly ensured your economic viability. This protection no longer exists. Low customs duties on imports also facilitated cheaper imports, strongly affecting industries like steel and textiles.

Microeconomic Factors:
These are the factors that essentially reflect the risks specific to the business enterprise. Some of these may be Product failure, product obsolescence, strained labor relations, inappropriate technology, raw material shortage, power shortage and price escalation. A striking example of this is the textile industry of Mumbai.
The factors causing NPAs may be further classified as factors internal and external to the lender.

Internal Factors:
Inadequate credit appraisal and monitoring systems followed by the lenders may lead to advances in excess of those merited by the project. Also there are avoidable inadequacies in the follow up process, thus delaying timely intervention. The unwillingness of the DFIs to share credit information with each other is another hindrance.

External Factors:
The Indian legal system has also been a major impediment in reducing the NPA levels. The existing framework is sympathetic towards the borrowers and works against the FDI's interest. Despite most of their loans being backed by security, FDI's are unable to enforce their claims on collateral, when the loans turn non-performing, and therefore, loan recoveries have been insignificant. There are different clauses that exist for DFIs that says that the debtor-creditor relationship is confidential. There isn't any need felt by the DFIs to disclose the debtors. Most of the DFIs take a long time to classify their a particular account as a NPA. Therefore there is a clear case of lack of transparency on the part of the DFIs.

Company Name	Family Group	Loan Rs (cr)	Institution	Terms of debt were eased as follows:
Essar Steel	Ruai	1900	ICICI,IDBI,LIC	Reduction of interest from 17% to 14%

Jindal Strips	O.P.Jindal	350	ICICI,IFCI,GIC	Reduction of interest from 20% to 14%
Jindal Vijaynagar Steel	Jindal	2693	ICICI,IDBI,LIC	Debt partly converted to equity
Indo Rama Synthetics	O.P.Lohia	1000	IFCI,IFC,IDBI, ICICI	Loan moratorium of 2 years

Besides NPAs there are other obstacles that have hampered the performance and role of the DFIs over the years. They are:

High Borrowing Costs

Government guaranteed SLR and other bonds, which used to be the pre-dominant source of funding till 1993, has been phased out in accordance with the reform process. These account for less than 10% of asset base of DFIs and are due for repayment within 3-4 years. The DFIs now face a lot of pressure on their borrowing costs as banks are competing in each area (banks have a much wider access to deposits, especially low cost demand deposits). As a result the spreads are under pressure, and thus the long term outlook looks unfavorable. The DFIs don't have any access to generation of funds from the retail sources like fixed deposits, and thus they generally borrow at 10-11 percent by issue of bonds.

Inefficiency and Corruption

Inefficiency and Corruption has been one of an age-old problem for most of the financial institutions in India. Most of their employees lack proper training, work culture, and attitude. At times, they accept bribes and get involved in under hand dealings. They lack the touch of professionalism, which is present in private sector companies. Most of the problems faced by the DFIs are due to inefficiency and corruption. There is corruption not only at the lower levels but also at the executive levels.

Competition

The DFIs face competition from commercial banks in financing. The large commercial banks also provide medium term and long term loans, especially, since 1997. The DFIs are also facing competition from the corporate customers who seem to have found cheaper avenues to borrow funds from. Most of the corporate are approaching the markets directly for loans, and therefore the DFIs are facing more competition. The fund based income is thus under severe pressure. The DFIs like the ICICI are thus looking to cater to retail consumers and focus more on fee-based income.

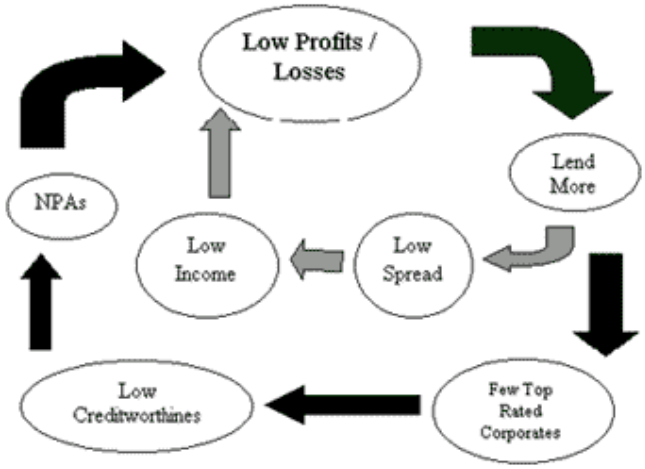
Lack of Transparency

In India, secrecy has always been a tradition. If partial disclosure sounds bad enough, how about not revealing anything at all. Walk into the office of a large Financial Institution and , ask for a balance sheet, and you are informed by a senior executive that the institution publishes "only one balance sheet , and that goes to Parliament. From 1998, the central bank has started to put on its web site a list of willful defaulters compiled from information submitted by the DFIs. Once you read through the list you shall realize that the small companies are mentioned, but what about the big company. Due to lack of transparency, there is no accountability and therefore results in a misappropriation of funds for vested interest.

Interference by Government

There has always been to much interference by the government in the working of these institutions. There are many rules and regulations set by the government which have to be followed. These institutions have to lend a fix portion of their advances to the priority sector. Over the years these advances to the priority have accounted for at least 50-60% of the NPAs.
The problems faced by the DFIs can be illustrated with the help of a vicious circle:

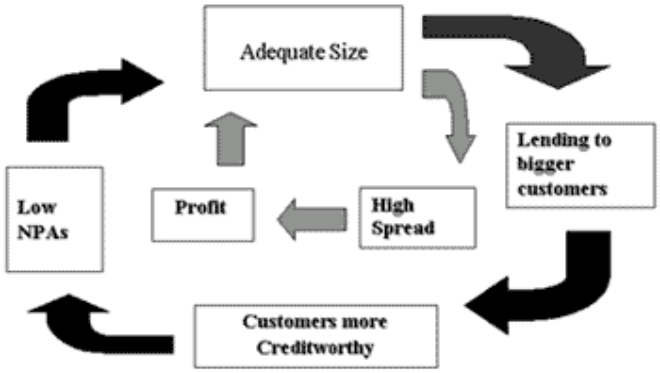
The Vicious



If we take a look at the above diagram, the DFIs are currently making low profits and losses. To improve their financial position they want to lend more. The problem they face at this step is that, their cost of borrowings is very high, as they don't have access to the retail sources. Banks have a privilege as they can raise money at around 7-8% from the public deposits, whereas the DFIs have to be content with raising funds at 10%. As a result their spreads get affected and also they don't get an opportunity to lend to the top rated corporate who have cheaper avenues to raise money from. In today's scenario, the tops rated corporate have an excellent standing and they can approach the markets directly. As a result they have to lend to the lesser rated corporate and thus their asset quality gets affected and results in an increase in the net NPAs of the DFIs which in turn affects the profitability.

A possible way to break away from this vicious circle is explained below with the help of a diagram.

A Universal Bank



As shown by the above diagram, the DFIs, converting themselves into a

Universal Bank, will be able to lower their cost of borrowings as they have access to retail sources. As a result of the reduced cost of borrowings they can reduce their lending rates and thus attract more top rated corporate and thus improve their NPA position and thus the profitability. Their total asset base will also increase as in the case of ICICI whose total asset base is Rs 95,000 crore. As a result the ratio of Net NPAs to Total Assets will also decrease, thus giving them a better valuation in the market. Being a universal bank, they not only have fund-based income but also fee based like auto loans, credit cards, home loans, etc. They will thus be a one stop financial superstore catering to the diverse needs of numerous individuals.
ICICI Universal Banking model: The new model of ICICI under the holding company structure has an asset base of approx. 95000 crores with 9 million Customers. The ICICI Bank functioning as a one stop financial store now specializes in different products. The products offered range from insurance, filing tax returns, stock trading to issuing petro-cards, which form the basic necessities of any individual. Thus ICICI today figures along with market leaders across all sectors who have gained a huge market share in their category.

Universal Banking

Meaning: The term 'universal banks' in general refers to the combination of commercial banking and investment banking, i.e., issuing, underwriting, investing and trading in securities. In a very broad sense, however, the term 'universal banks' refers to those banks that offer a wide range of financial services, beyond commercial banking and investment banking, such as, insurance. However, universal banking does not mean that every institution conducts every type of business with every type of customer. Universal banking is an option; a pronounced business emphasis in terms of products, customer groups and regional activity can, in fact, be observed in most cases. In the spectrum of banking, specialised banking is on the one end and the universal banking on the other.

Advantages:
1. Greater economic efficiency: The main argument in favor of universal banking is that it results in greater economic efficiency in the form of lower cost, higher output and better products. This logic stems from the reason that when sector participants are free to choose the size and product-mix of their operations, they are likely to

configure their activities in a manner that would optimize the use of their resources and circumstances.
2. Reducing Risks: Due to various shifts in business cycles, the demand for products also varies at different points of time. It is generally held that universal banks could easily handle such situations by shifting the resources within the organisation as compared to specialised banks. Specialised firms are also subject to substantial risks of failure, because their operations are not well diversified. By offering a broader set of financial products than what a specialised bank provides, it has been argued that a universal bank is able to establish long-term relationship with the customers and provide them with a package of financial services through a single window.
3. Cross Selling: The universal banking concept helps in the cross selling strategy by helping both the financial institutions and the banks to target their end customers.
4. Focus on retail: This concept focuses on retail business by offering a wide range of products thereby ensuring a steady flow of income over the corporate clients.

Disadvantages of Universal Banking: -
1. Systemic Risk: The larger the banks the greater the effects of their failure on the system. The failure of a larger institution could have serious ramifications for the entire system in that if one universal bank were to collapse, it could lead to a systemic financial crisis. Thus, universal banking could subject the economy to the increased systemic risk.
2. Monopoly: Historically, an important reason for limiting combinations of activities has been the fear that such institutions, by virtue of their sheer size, would gain monopoly power in the market, which can have significant undesirable consequences for economic efficiency. Two kinds of concentration should be distinguished, *viz*., the dominance of universal banks over non-financial companies and concentration in the market for financial services. The critics of universal banks blame universal banking for fostering cartels and enhancing the power of large non-banking firms.
3. Bureaucratic and inflexible: Some critics have also observed that universal banks tend to be bureaucratic and inflexible and hence they tend to work primarily with large established customers and ignore or discourage smaller and newly established businesses. Universal banks could use such practices as limit pricing or predatory pricing to prevent smaller specialised banks from serving the market. This argument mainly stems from the economies of scale and scope.
4. Conflict of interests: Combining commercial and investment banking gives rise to conflict of interests as universal banks may not objectively advise their clients on optimal means of financing or they may have an interest in securities because of underwriting activities. These conflicts could be between the investment banker's promotional role and the commercial banker's obligation to provide disinterested advice or using the bank's securities department or affiliate to issue new securities to repay unprofitable loans etc

ROAD MAP:
1. Convert the financial institution into a bank over a period of time: It is recommended that a full banking license be eventually granted to DFIs. In the interim, DFIs may be permitted to have banking subsidiaries (with holdings up to 100 per cent), while the DFIs themselves may continue to play their existing role. It also recommended that management and shareholders of banks and DFIs should be

permitted to explore and enter into gainful mergers. These mergers should be possible not only between banks but also between banks and DFIs. There would then be only two forms of intermediaries, viz., banking companies and non-banking finance companies. If a DFI does not acquire a banking license within a stipulated time it would be categorized as a non-banking finance company. A DFI, which converts into a bank, can be given some time to phase in reserve requirements in respect of its liabilities to bring it on par with the requirements relating to commercial banks. Similarly, as long as a system of directed credit is in vogue a formula should be worked out to extend this to DFIs, which have become banks.

2.Mergers based on synergies and location, and business specific: Mergers between banks and DFIs and NBFCs need to be based on synergies and location and business specific complementarities of the concerned institutions and must obviously make sound commercial sense. Mergers between strong banks/FIs would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of its parts and have a "force multiplier effect".

3. System of regulation and supervision: It recommended that the banks/DFIs should be supervised on a consolidated basis. Future accounting standards must consequently include rules on consolidated supervision for financial subsidiaries and conglomerates. Further, as domestic financial entities assume an international character, banking supervisors should adopt global consolidated supervision (instead of mere national regulation). For meaningful consolidated supervision – both domestic and global we recommend the development of a "risk-based supervisory framework. For effective supervision, it observed that there is a need for formal accession to 'core principles' announced by the Basle Committee. The Narasimham Committee had recommended that the RBI should direct banks to publish, in addition to financial statements as independent entities, a consolidated balance sheet to reveal the true financial position of the group. Full disclosure would also be required of connected lending and lending to sensitive sectors. Furthermore, it should also ask banks to disclose loans given to related companies in the banks' balance sheets. Full disclosure of information should not be only a regulatory requirement. It would be necessary to enable bank's creditors, investors and rating agencies to get a true picture of its functioning – an important requirement in a market driven financial sector. This observation of the Narasimham Committee is equally applicable to DFIs, especially when there is a bank directly under its umbrella

4. Machinery for Debt recovery: There should be a proper framework adopted through agencies who support in ensuring steady recovery of loans given by financial institutions. This mechanism should be able to ensure recovery of past debts along with a credit appraisal system for the lending fresh in the market.

5. Organizational Redesign: Best practices in the area of corporate governance such as imparting full operational autonomy and flexibility to management's and Boards of Banks and DFIs should be implemented. A complete redesign of the business system of banks/DFIs, with the Top Management spelling out the strategic objectives for principal stakeholders (clients, employees, shareholders, etc.), a proactive relationship-based approach in corporate culture, a consensus-driven committee-based

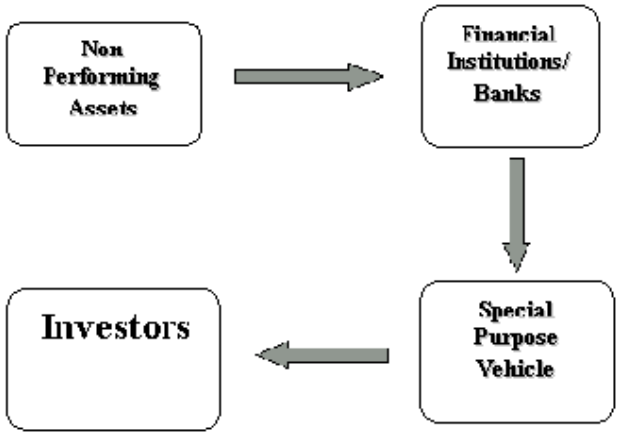
approach for loan sanctions and decisions on organisation structure based purely on commercial judgment.

6. Human Resource development: There should be broad-based recruitment's, both at entry level from campus as well as lateral entry of professionals at higher levels to fill skill gaps in critical areas. They should have systematic training programs, skill building and upgradation workshops, market-based compensation packages along with a viable and enforceable exit option for employees. A Special Vigilance Machinery exclusively for the financial sector on the lines of Serious Fraud Office (SFO) of the U.K may be set up.

Securitisation: Once these DFIs have converted themselves into Universal Banks, there still exist the problem of the current NPA level. In the Indian banking scenario, immediate attention needs to be diverted at increasing level of threat provided by the high amount of NPA.. This labyrinth leads us a glimmer of hope in the form of Securitisation of Non Performing Assets.

By the process of Securitisation bank can get rid of the NPAs and avoid the recapitalisation need by reducing the size of their balance sheet. This will lead to substantial release and generation of funds, which can then be applied for generation of productive assets. The assets are transferred by way of a true sale to a *SPV (Special Purpose Vehicle),* which in turn raises funds in the capital market by issuing securities on the basic of these assets. These securities could be in the form of a 3-5 year Bonds carrying a suitable interest rate. The government at this stage only needs to guarantee a steady return to the investors and capital redemption on maturity thus avoiding the need for immediate capital infusion.

Model for Securitisation



The cash flows from the restructured NPAs should take care of the return and capital needs relieving the Government. Even if a portion is not recovered despite all attempts, the Government will need to pull out its coffers only after 3-5 years. Avoidance of this calls for strong structural and legal background, which has to be provided. With the world identifying Securitization as a potential for solving the Non Performing Loan problem Indian cannot keep its eyes shut for long.

Valuation of Assets

Valuation of assets is a very crucial matter in the securitization process. If the SPV is government owned the issue should not cause much impediment as a mutually agreed

valuation can be arrived at. However pricing assumes greater proportions when the assets are transferred to private players. It is very necessary to bifurcate the assets in three categories which would attract different coupon rates. The three categories being

1) Sub-Standard Assets
2) Doubtful Assets
3) Loss Assets.

Conclusion:

Given the laxity of the government in implementation of corrective measures the success of the securitization measure remains only a hypothesis. Securitization will require an overhauling of the entire banking structure backed by a strong legal and regulatory framework. More than anything else this will require strong will on the part of the government. Till then the Indian banks will continue to pile up heaps of NPAs and economy wait for the disaster to strike.

LESSON 31
MUTUAL FUNDS AND DEVELOPMENT FINANCIAL INSTITUTIONS: WHAT'S HAPPENING?

Lesson Objectives: **To make aware of latest in the field of mutual funds and development financial institutions with respect to operations, players and government policy.**

Dear Students, we have discussed a lot about the working of DFIs and MFs, and as you are aware, lot of changes have taken place in the governments policy and market scenario, since the above chapters were written few months back and till today.

Purpose of this session is to make you aware of latest in the DFIs and MFs sector. So, to achieve our purpose, you all have to make small groups of four members each and collect all possible latest information regarding DFIs and MFs including news clippings, government policy changes, merger and acquisition news, and any other relevant information, which you consider is worth discussing in a group to share knowledge.

LESSON 32
TUTORIAL

Lesson Objectives: **To clear all the doubts of the students related to concepts covered in various topics so far covered**

Dear Students, so far we have covered around two third of the total course of this particular subject. We have made all efforts to enable you to understand the concepts and their practical usage as an aspiring manager / entrepreneur.

Today's session is just to solve all your difficulties in topics so far covered. If you have any doubt or require any clarification on any topic, lets discuss that.

I also want you to get more and more involved in information sharing. This serves two purposes – you get more knowledge and your communication improves. So, collect information, discuss that with your colleagues and if you have any doubts, your faculties are there to help you.

The purpose of our study is not just to learn the theoretical concept, but also to understand their practical / actual usage in day to day life. Hence it is very important for you to collect such information and share / discuss it with your colleagues.

LESSON 33
ISSUE MANAGEMENT: ISSUE RELATED ACTIVITIES AND SEBI GUIDELINES

Lesson Objectives: **To understand the process of issue management and SEBI guidelines related to issue management activity.**

INTRODUCTION

Issue management, now days, is one of the very important fee based services provided by the financial institutions. In recent past various companies have entered into issue management activities. Still there are very few large scale and specialized issue management agencies in the country. With the growth of stock market and opening up of economy, the scope for issue management activity is widening day by day. To protect the investors' interest and for orderly growth and development of market, SEBI has put in place guidelines as ground rules relating to new issue management activities. These guidelines are in addition to the company law requirements in relation to issues of capital / securities.

Financial instruments can be classified into two main groups – share capital and debt capital. There are various other classifications in each of the two categories. Also, there are various types of company's i.e. listed, unlisted, public, private etc. For each of them SEBI has issued comprehensive guidelines, related to issue of financial instruments.

Let us discuss all these issue management activities in detail, one by one.

ELIGIBILITY NORMS:

To make an issue, the company must fulfill the eligibility norms specified by SEBI and Companies Act. The companies issuing securities through an offer document, that is (a) prospectus in case of public issue or offer for sale and (b) letter of offer in case of right issue, should satisfy the eligibility norms as specified by SEBI, below:

Filing of Offer Document: In the case of a public issue of securities, as well as any issue of security, by a listed company through rights issue in excess of Rs. 50 lakh, a draft prospectus should be filed with SEBI through an eligible registered merchant banker at least 21 days prior to filing it with ROC. Companies prohibited by SEBI, under any order/direction, from accessing the capital market cannot issue any security.

The companies intending to issue securities to public should apply for listing them in recognized stock exchange(s). Also, all the issuing companies must (a) enter into an agreement with a depository registered with SEBI for dematerialization of securities already issued / proposed to be issued and (b) give an option to subscribers / shareholder / investors to receive security certificates or hold securities in a dematerialized form with a depository.

Public issue / Offer for sale by Unlisted Companies: An unlisted company can make a public issue / offer for sale of equity shares / security convertible into equity shares on a late date if it has in three out of preceding five years (a) a pre issue net worth of Rs. 1 crore (b) a track record of distributable profit in terms of Sec. 205 of the Companies

Act. The size of the issue should not exceed five times of the pre-issue net worth as per last available audited accounts either at the time of filing of offer or at the time of opening of issue.

There are separate norms for companies in the information technology sector and partnership firms converted into companies or companies formed out of a division on an existing company.
If the unlisted company does not comply with the aforesaid requirement of minimum pre-issue net worth and track record of distributable profits or its proposed size exceeds five times its pre-issue net worth, it can issue shares / convertible security only through book building process on the condition that 60% of the issue size would be allotted to qualified institutional buyers (QIB) failing which the full subscription should be refunded.

Public issue by listed companies: All listed companies are eligible to make a public issue of equity shares/ convertible securities if the issue size does not exceed five times its pre-issue net worth as per the last available audited accounts at the time of either filing of documents with SEBI or opening of the issue. A listed company which does not satisfy this condition would be eligible to make issue only through book building process on the condition that 60% of the issue size would be allotted to QIBs, failing which full subscription money would be refunded.

Exemption: The eligibility norms specified above are not applicable in the following cases:

- Private sector banks
- Infrastructure companies, wholly engaged in the business of developing, maintaining and operating infrastructure facility within the meaning of Sec. 10(23-G) of the Income Tax Act (a) whose project has been appraised by a public financial institution / IDFC/ILFS and (b) not less than 5% of the project cost has been financed by any of the appraising institutions jointly / severally by way of loan / subscription to equity or combination of both and
- Rights issue by a listed company.

Credit Rating for Debt Instruments: A debt instrument means an instrument / security which creates / acknowledges indebtedness and includes debentures, bonds and such other securities of a company whether constituting charge on its assets or not. For issue, both public and rights, of a debt instrument, including convertibles, credit rating – irrespective of the maturity or conversion period – is mandatory and should be disclosed. The disclosure should also include the unaccepted credit rating. Two ratings from two different credit rating agencies registered with SEBI should be obtained in case of public/rights issue of Rs.100 crore and more. All credit ratings obtained during the three years preceding the public/rights issue for any listed security of the issuing company should also be disclosed in the offer document.

Outstanding Warrants / Financial Instruments: An unlisted company is prohibited from making a public issue of shares / convertible securities in case there are any outstanding financial instruments / any other rights entitling the existing promoters / shareholders any option to receive equity share capital after the initial public offering.

Partly Paid-up Shares: Before making a public / rights issued of equity shares / convertible securities, all the existing partly paid up shares should be made fully paid up or forfeited if the investor fails to pay call money within 12 months.

PRICING OF ISSUES

A listed company can freely price shares/convertible securities through a public/ rights issue. An unlisted company eligible to make a public issue and desirous of getting its securities listed on a recognized stock exchange can also freely price shares and convertible securities. The free pricing of equity shares by an infrastructure company is subject to the compliance with disclosure norms as specified by SEBI from time to time. While freely pricing their initial public issue of shares/ convertible, all banks require approval by the RBI.

Differential Pricing: Listed/unlisted companies may issue shares/convertible securities to applicants in the firm allotment category at a price different from the price at which the net offer to the public is made, provided the price at which the securities are offered to public.

A listed company making a composite issue of capital may issue securities at differential prices in its public and rights issue. In the public issue, which is a part of a composite issue, differential pricing in firm allotment category vis-à-vis the net offer to the public is also permissible. However, justification for the price differential should be given in the offer document in case of firm allotment category as well as in all composite issues.

Price Band: The issuer / issuing company can mention a price band of 20% (cap in the price band should not exceed 20% of the floor price) in the offer document filed with SEBI and the actual price can be determined at a later date before filing it with the ROC. If the BOD of the issuing company has been authorized to determine the offer price within a specified price band, a resolution would have to be passed by them to determine such a price. The lead merchant banker should ensure that in case of listed companies, a 48 hours notice of the meeting of BOD for passing the resolution for determination of price is given to the regional stock exchange. The final offer document should contain only one price and one set of financial projections, if applicable.

Payment of Discount / Commissions: Any direct or indirect payment in the nature of discount / commission / allowance or otherwise cannot be made by the issuer company / promoter to any firm allottee in a public issue.

Denomination of Shares: Public / rights issue of equity shares can be made in any denomination in accordance with Sec. 13(4) of the Companies Act and in compliance with norms specified by SEBI from time to time. The companies which have already issued shares in the denominations of Rs. 10 or Rs. 100 may change their standard denomination by splitting / consolidating them.

PROMOTERS' CONTRIBUTION AND LOCK-IN REQUIREMENTS

Regulations regarding promoters' contribution are discussed as under:

Public issue by unlisted companies: The promoters should contribute at least 20% and 50% of the post issue capital in public issue at par and premium respectively. In case the issue size exceeds Rs. 100 crores, their contribution would be computed on the basis of total equity to be issued, including premium at present and in the future, upon conversion of optionally convertible instruments, including warrants. Such contribution may be computed by applying the slab rated mentioned below:

Size of Capital Issue (including premium)	Percentage of contribution
On first Rs. 100 crores	50
On next Rs. 200 crores	40
On next Rs. 300 crores	30
On balance	15

While computing the extent of contribution, the amount against the last slab should be so adjusted that on an average the promoters' contribution is not less than 20% of post issue capital after conversion.

Offer for sale by unlisted companies: The promoters' shareholding, after offer for sale, should at least 20% of the post issue capital.

Public issue by listed companies: The participation of the promoters should either be (i) to the extent of 20% of the proposed issue or (ii) to ensure shareholding to the extent of 20% of the post-issue capital.

Composite issue by Listed Companies: At the option of the promoters, the contribution would be either 20% of the proposed public issue or 20% of the post-issue capital, excluding rights issue component of the composite issue.

Public Issue by unlisted infrastructure companies at premium: The promoters contribution, including contribution by equipment suppliers and other strategic investors, should be at least 50% of the post-issue capital at the same or a price higher than the one at which the securities are being offered to public.

Securities Ineligible for computation of promoters contribution: The securities specified below acquired by / allotted to promoters would not be considered for computation of promoters' contribution:

- Where before filing the offer document with SEBI, equity shares were acquired during the preceding three years (a) for consideration other than cash and revaluation of assets / capitalization of intangible assets is involved in such transactions and (b) from a bonus issue out of revaluation reserves or reserves without accrual of cash revenues;
- In the case of a public issue by unlisted companies, securities issued to promoters during the preceding one year at a price lower than the price at which equity is offered to the public.
- The shares allotted to promoters during the previous year out of funds brought in during that period in respect of companies formed by conversion of partnership firms where the partners of the firm and the promoters of the converted company are the same and there is no change in management unless such shares have been issued at the same price at which the public offer is made. However, if partners' capital existed in the firm for a period exceeding one year on a continuous basis, the shares allotted to promoters against such capital would be eligible.

The ineligible shares specified in the above three categories would, be eligible for computation of promoters contribution if they are acquired in pursuance of a scheme of merger/ amalgamation approved by a high court.

- Securities of any private placement made by solicitation of subscription from unrelated persons either directly or through an intermediary; and
- Securities for which a specific written consent has not been obtained from the respective shareholders for inclusion of their subscription in the minimum promoters contribution.
-

Issue of convertible security: In the case of issue of convertible security, promoters have an option to bring in their subscription by way of equity or subscription to the convertible security being offered so that their total contribution would not be less than the required minimum in cases of (a) par/ premium issue by unlisted companies (b) offer for sale, (c) issues/ composite issue by listed companies and (d) public issue at premium by infrastructure companies.

Promoters Participation in Excess of Required Minimum: In a listed company participation by promoters in excess of the required minimum percentage in public/ composite issues would be subject to pricing of preferential allotment, if the issue price is lower than the price as determined on the basis of preferential allotment pricing.

Promoters' contribution before public issue: Promoters should bring in the full amount of their contribution, including premium, at least one day before the public issue opens/ issue opening date which would be kept in an escrow account with a bank and would be released to the company along with the public issue proceed.

Exemption from Requirement of Promoters' Contribution: The requirement of promoters contribution is not applicable in the following three cases, although in all the cases, the shareholders should disclose in the offer document their existing shareholding and the extent to which they are participating in the proposed issue:

(a) Public issue by a company listed on a stock exchange for at least three years and having a track record of dividend payment for at least three immediately preceding years. However, if the promoters' participate in the proposed issue to the extent greater than higher of the two options available, namely, 20% of the issue or 20% of the post-issue capital, the excess contribution would attract pricing guidelines on preferential issues if the issue price is lower than the price as determined on the basis of the guidelines on preferential issue.
(b) Where no identifiable promoter / promoter group exists.
(c) Rights issue.

Lock-in requirements of Promoters' contribution: Promoters' contribution is subject to a lock-in period as detailed below:

Lock-n of Minimum Required Contribution: In case of any (all) issues of capital to the public, the minimum promoters' contribution would be locked in for a period of three years. The lock-in period would start from the date of allotment in the proposed issue and the last date of the lock-in period would be reckoned as three years from the date of commencement of commercial production or the date of allotment in the public issue, or whichever is later.

Lock-in excess promoters contribution: In the case of public issue by an unlisted company, excess promoters' contribution would be locked in for a period of one year. The excess contribution in a public issue by a listed company would also be locked in for a period of one year as per the lock-in provisions.
Securities issued last to be locked in first: The securities, forming part of the promoters' contribution issued last to them, would be locked in first for the specified period. However, if securities were issued last to financial institutions as promoters, these would not be locked in before the shares allotted to other promoters.
Lock-in of Pre-issue share capital of an unlisted company: The entire pre-issue share capital, other than locked in as promoters' contribution, would be locked-in for one year from the date of commencement of commercial production or the date of allotment in the public offer whichever is later.

Lock-in of securities issued on firm allotment basis: Securities issued on firm allotment basis would be locked in for one year from the date of commencement of commercial production, or date of allotment in public issue, whichever is later.
Other requirements in respect of Lock-in: The other requirements relating to the lock-in of promoters' contribution is discussed hereunder:
Pledge of securities: Locked-in securities held by the promoters may be pledged only with banks/financial institutions, as collateral security for loans granted by them provided the pledge of shares is one the terms of the sanction of the loan.
Inter-se transfer of Securities: Transfer of locked in securities amongst promoters as named in the offer document can be made subject to lock-in being applicable to the transferees for the remaining lock-in period.
Inscription of Non-transferability: The securities, which are subject to a lock-in period, should carry inscription 'non-transferable', along with duration of specified non-transferable period mentioned in the face of the security certificate.

ISSUE ADVERTISEMENT:
The term advertisement is defined to include notices, brochures, pamphlets, circulars, show cards, catalogues, placards, posters, insertions in newspapers, pictures, films, cover pages of offer documents or any other print medium, radio, television programs through any electronic media.
The lead merchant banker should ensure compliance with the guidelines on issue advertisement by the issuing companies.

ISSUE OF DEBT INSTRUMENTS:
A company offering convertible/non-convertible debt instruments through an offer document should, in addition to the other relevant provisions of these guidelines, complies with the following provisions:
Requirement of credit rating: A public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period can be made only if the credit rating has been obtained and disclosed in the offer document. For all issues greater than or equal to Rs.100 crore, two ratings from two different credit rating agencies should be obtained.
Requirements in Respect of Debenture Trustees: In the case of issue of debentures with maturity of more than 18 months, the issuer should appoint debenture trustees whose name must be stated in the offer document. The issuer company in favor of the

debenture trustees should execute a trust deed within six months of the closure of the issue.

Creation of Debenture Redemption Reserves (DRR): A company has to create DRR in the case of the issue of debentures with maturity of more than 18 months.
Distribution of Dividends: In the case of new companies, distribution of dividends would require the approval of the trustees to the issue and the lead institution, if any. In case of existing companies, prior permission of the lead institution for declaring dividend, exceeding 20% as per the loan covenants, is necessary if the company does not comply with institutional condition regarding interest and debt service coverage ratio.

Redemption: The issuer company should redeem the debentures as per the offer documents.

Disclosure and Creation of Charge: The offer document should specifically state the assets on which the security would be created as also the ranking of the charge(s). In the case of second/residual charge or subordinated obligation, the risks associated with should clearly be stated.

Filing of Letter of Option: A letter of option containing disclosures with regards to credit rating, debentures holders resolution, option for conversion, justification for conversion price and such other terms which SEBI may prescribe from time to time should be filed with SEBI through an eligible merchant banker, in case of a roll over of non-convertible portions of PCD/NCDs, etc.

BOOK BUILDING

Book-building means a process by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of notice/ circular / advertisement/ document or information memoranda or offer document. A company proposing to issue capital through book-building has to comply with the requirements of SEBI in this regard. These are discussed here.
75% Book Building Process: The option of book-building is available to all body corporate which are eligible to make an issue of capital to the public as an alternative to and to the extent of the percentage of the issue, which can be reserved for firm allotment. The issuer company can either reserve the securities for firm allotment or issue them through book-building process. The issue of securities though book-building route should be separately identified/indicated as 'placement portion category' in the prospectus. The securities available to the public should be separately identified as 'net offer to the public'. The requirement of minimum 25% of the securities to be offered to the public is also applicable. Underwriting is mandatory to the extent of the net offer to the public. The draft prospectus containing all the details except the price at which the securities are offered should be filed with SEBI. The issuer company should nominate one of the lead merchant bankers to the issue as book runner, and his name should be mentioned in the prospectus. The copy of the draft prospectus, filed with SEBI, should be circulated by the book runner to the

institutional buyers, who are eligible for firm allotment, and to the intermediaries, eligible to act as underwriters inviting offers for subscription to the securities.
100% Book Building Process: In an issue of securities to the public through a prospectus, the option for 100% book building is available to any issuer company. The issue of capital should be Rs. 25 crore and above. Reservation for firm allotment to the extent of the percentage specified in the relevant SEBI guidelines can be made only to promoters, 'permanent employees of the issuer company and in the case of new company to the permanent employees of the promoting company'. It can also be made to shareholders of the promoting companies, in the case of new company and shareholders of group companies in the case of existing company either on a competitive basis or on a firm allotment basis. The issuer company should appoint eligible merchant bankers as book runner(s) and their names should be mentioned in the draft prospectus. The lead merchant banker should act as the lead book runner and the other eligible merchant bankers are termed as co-book runner. The issuer company should compulsorily offer an additional 10% of the issue size offered to the public through the prospectus.

IPO THROUGH STOCK EXCHANGE ON-LINE SYSTEM (E-IPO):
In addition to other requirements for public issue as given in SEBI guidelines wherever applicable, a company proposing to issue capital to public through the on-line system of the stock exchange for offer of securities has to comply with the additional requirements in this regard. They are applicable to the fixed price issue as well as for the fixed price portion of the book-built issues. The issuing company would have the option to issue securities to public either through the on-line system of the stock-exchange or through the existing banking channel. For E-IPO the company should enter into agreement with the stock-exchange(s) and the stock-exchange would appoint SEBI registered stockbrokers of the stock exchange to accept applications. The brokers and other intermediaries are required to maintain records of (a) orders received, (b) applications received, (c) details of allocation and allotment, (d) details of margin collected and refunded and (e) details of refund of application money.

ISSUE OF CAPITAL BY DESIGNATED FINANCIAL INSTITUTIONS:
Designated financial institutions (DFI), approaching the capital market for fund though an offer document, have to follow following guidelines.
Promoters' contributions: There is no requirement of minimum promoters' contribution in the case of any issue by DFIs. If any DFI proposes to make a reservation for promoters, such contribution should come only from actual promoters and not from directors, friends, relatives and associates, etc.
Reservation for employees: The DFIs may reserve out of the proposed issues for allotment only to their permanent employees, including their MD or any fulltime director. Such reservations should be restricted to Rs. 2000 per employee, subject to five percent of the issue size. The shares allotted under the reserved category are subject to a lock-in for a period of three years.
Pricing of the issue: The DFIs, may freely price the issues in consultation with the lead managers, if the DFIs have a three years track record of consistent profitability out of immediately preceding five years, with profit during last two years prior to the issue.

PREFERENTIAL ISSUE:

The preferential issue of equity shares/ fully convertible debentures (FCD)/ partly convertible debentures (PCDs) or any other financial instruments, which would be converted into or exchanged with equity shares at a later date by listed companies to any select group of persons under section 81(1A) of the Companies Act, 1956 on a private placement basis, are governed by the following guidelines:

Pricing of issue: The issue of shares on a preferential basis can be made at a price not less than the higher of the following: (i) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange and (ii) The average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

Pricing of Shares arising out of warrants: Where warrants are issued on a preferential basis with an option to apply for and be allotted shares, the issuer company should determine the price of the resultant shares in accordance with the provisions discussed in the above point.

Pricing of shares on Conversion: Where PCDs/FCDs/ other convertible instruments are issued on a preferential basis, providing for the issuer to allot shares at a future date, the issuer should determine the price at which the shares could be allotted in the same manner as specified for pricing of shares allotted in lieu of warrants.

Currency of Financial Instruments: In the case of warrants / PCDs / FCDs / or any other financial instruments with a provision for the allotment of equity shares at a future date, either through conversion or otherwise, the currency of the instruments cannot exceed beyond 18 months from the date of issue of the relevant instruments.

Non-transferability of Financial Instruments: The instruments allotted on a preferential basis to the promoters / promoter groups are subject to a lock-in period of three years from the date of allotment. In any case, not more than 20% of the total capital of the company, including the one brought in by way of preferential issue would be subject to a lock-in period of three years from the date of allotment.

Currency of Shareholders' Resolutions: Any allotment pursuant to any resolution passed at a meeting of shareholders of a company granting consent for preferential issues of any financial instrument, should be completed within a period of three months from the date of passing of the resolution.

Certificate from Auditors: In case every issue of shares/FCDs/PCDs/ or other financial instruments has the conversion option, the statutory auditors of the issuer company should certify that the issue of said instruments is being made in accordance with the requirements contained in these guidelines.

OTCEI ISSUES:

A company making an initial public offer of equity shares / convertible securities and proposing to list them on the Over The Counter Exchange of India (OTCEI) has to comply with following requirements:

Eligibility Norms: Such a company is exempted from the eligibility norms applicable to unlisted companies, provided (i) it is sponsored by a member of the OTCEI and (ii) has appointed at least two market makers. Any offer of sale of equity shares / convertible securities resulting from a bought out deal registered with OTCEI is also exempted from the eligibility norms subject to the fulfillment of the listing criteria laid down by the OTCEI.

Pricing norms: Any offer for sale of equity shares or any other convertible security resulting from a bought out deal registered with OTCEI is exempted from the pricing norms specified for unlisted companies, subject to following conditions: (a) The promoters after such issue would retain at least 20% of the total issued capital with a lock-in of three years from the date of the allotment of securities in the proposed issue and (b) at least two market makers are appointed in accordance with the market making guidelines stipulated by the OTCEI.

Projection: In case of securities proposed to be listed on the OTCEI, projections based on the appraisal done by the sponsor who undertakes to do market-making activity can be included in the offer document subject to compliance with the other conditions relating to the contents of offer documents.

LESSON 34
ISSUE MANAGEMENT: INTERMEDIARIES, REGULATIONS AND SEBI GUIDELINES

Lesson Objectives: **To understand the role of intermediaries in the issue management activity and**
SEBI norms for intermediaries in relation to issue management activities.

INTRODUCTION:

The new issue market / activity was regulated by the Controller of Capital Issues (CCI) under the provisions of the Capital Issues (Control) Act, 1947 and the exemption orders and rules made under it. With the repeal of the Act and the consequent abolition of the office of the CCI in 1992, the protection of the interest of the investors in securities market and promotion of the development and regulation of the market/ activity became the responsibility of the SEBI. To tone up the operations of the new issues in the country, it has put in place rigorous measures. These cover both the major intermediaries as well as the activities.

So, we will discuss here, various intermediaries, their regulation and SEBI guidelines related to them.

MERCHANT BANKERS:

In modern times, importance of merchant banker is very much, because it the key intermediary between the company and issue of capital. Main activities of the merchant bankers are – determining the composition of the capital structure, drafting of prospectus and application forms, compliance with procedural formalities, appointment of registrars to deal with the share application and transfer, listing of securities, arrangement of underwriting / sub-underwriting, placing of issues, selection of brokers, bankers to the issue, publicity and advertising agents, printers and so on.

Due to overwhelming importance of merchant banker, it is now mandatory that merchant banker(s) functioning as lead manager(s) should manage all public issues. In case of rights issue not exceeding Rs.50 lakh, such appointments may not be necessary. The salient features of the SEBI framework, related to merchant bankers are discussed as under.

Registration : Merchant bankers require compulsory registration with the SEBI to carry out their activities. Previously there were four categories of merchant bankers, depending upon the activities. Now, since Dec. 1997, there is only one category of registered merchant banker and they perform all activities.

Grant of Certificate : The SEBI grants a certificate of registration to applicant if it fulfills all the conditions like (i) it is a body corporate and is not a NBFC (ii) it has got necessary infrastructure to support the business activity (iii) it has appointed at least

two qualified and experienced (in merchant banking) persons (iv) its registration is in the general interest of investors.

Capital Adequacy Requirement : A merchant banker must have adequate capital to support its business. Hence SEBI grants recognition to only those merchant bankers who have paid up capital and free reserves of minimum Rs. 1 crore.
Fee: A merchant banker has to pay a registration fee of Rs. 5 lakh and renewal fees of Rs. 2.5 lakh every three years from the fourth year from the date of registration.

Code of Conduct : Every merchant banker has to abide by the code of conduct, so as to maintain highest standards of integrity and fairness, quality of services, due diligence and professional judgment in all his dealings with the clients and other people. A merchant banker has always to endeavor to (a) render the best possible advice to the clients regarding clients needs and requirements, and his own professional skill and (b) ensure that all professional dealings are effected in a prompt, efficient and cost effective manner.

Restriction on Business : No merchant banker, other than a bank/public financial institution is permitted to carry on business other than that in the securities market w.e.f. Dec.1997. However a merchant banker who is registered with RBI as a primary dealer/satellite dealer may carry on such business as may be permitted by RBI w.e.f. Nov.1999.

Maximum number of lead managers : The maximum number of lead managers is related to the size of the issue. For an issue of size less than Rs. 50 crores, two lead managers are appointed. For size groups of 50 to 100 crores and 100 to 200 crores, the maximum permissible lead managers are three and four respectively. A company can appoint five and five or more (as approved by SEBI) lead managers in case of issue sizes between Rs.200 to 400 crores and above Rs.400 crores respectively.
Responsibilities of Lead Managers : Every lead manager has to enter into an agreement with the issuing companies setting out their mutual rights, liabilities and obligation relating to such issues and in particular to disclosure, allotment and refund. A statement specifying these is to be furnished to the SEBI at least one month before the opening of the issue for subscription. It is necessary for a lead manager to accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs. 25 lakh whichever is less.

Due diligence certificate : The lead manager is responsible for the verification of the contents of a prospectus / letter of offer in respect of an issue and the reasonableness of the views expressed in them. He has to submit to the SEBI at least two weeks before the opening of the issue for subscription a due diligence certificate.
Submission of documents : The lead managers to an issue have to submit at least two weeks before the date of filing with the ROC/regional SE or both, particulars of the issue, draft prospectus/ letter of offer, other literature to be circulated to the investors / shareholders, and so on to the SEBI. They have to ensure that the modifications/ suggestions made by it with respect to the information to be given to the investors are duly incorporated.

Acquisition of Shares : A merchant banker is prohibited from acquiring securities of any company on the basis of unpublished price sensitive information obtained during the course of any professional assignment either from the client or otherwise.

Disclosure to SEBI : As and when required, a merchant banker has to disclose to SEBI (i) his responsibilities with regard to the management of the issue, (ii) any change in the information/ particulars previously furnished which have a bearing on the certificate of registration granted to it, (iii) names of the companies whose issues he has managed or has been associated with (iv) the particulars relating to the breach of capital adequacy requirements and (v) information relating to his activities as manager, underwriter, consultant or advisor to an issue.

Action in case of Default : A merchant banker who fails to comply with any conditions subject to which the certificate of registration has been granted by SEBI and / or contravenes any of the provisions of the SEBI Act, rules or regulations, is liable to any of the two penalties (a) Suspension of registration or (b) Cancellation of registration.

UNDERWRITERS

Another important intermediary in the new issue/ primary market is the underwriters to issue of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organization is an important element of primary market. Underwriters are appointed by the issuing companies in consultation with the lead managers / merchant bankers to the issues.

Registration : To act as underwriter, a certificate of registration must be obtained from SEBI. On application registration is granted to eligible body corporate with adequate infrastructure to support the business and with net worth not less than Rs. 20 lakhs.

Fee : Underwriters had to pay Rs. 5 lakh as registration fee and Rs. 2 lakh as renewal fee every three years from the fourth year from the date of initial registration. Failure to pay renewal fee leads to cancellation of certificate of registration.
General Obligations and responsibilities :

Code of conduct : Every underwriter has at all times to abide by the code of conduct; he has to maintain a high standard of integrity, dignity and fairness in all his dealings. He must not make any written or oral statement to misrepresent (a) the services that he is capable of performing for the issuer or has rendered to other issues or (b) his underwriting commitment.

Agreement with clients : Every underwriter has to enter into an agreement with the issuing company. The agreement, among others, provides for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by/on behalf of the issuer, the amount of commission/brokerage, and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations.

General responsibilities : An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than by the underwriting commission. The maximum obligation under all underwriting agreements of an underwriter cannot exceed twenty times his net worth. Underwriters have to subscribe for securities under the agreement within 45 days of the receipt of intimation from the issuers.

BANKERS TO AN ISSUE

The bankers to an issue are engaged in activities such as acceptance of applications along with application money from the investor in respect of capital and refund of application money.

Registration : To carry on activity as a banker to issue, a person must obtain a certificate of registration from the SEBI. The applicant should be a scheduled bank. Every banker to an issue had to pay to the SEBI an annual free for Rs. 5 lakh and renewal fee or Rs. 2.5 lakh every three years from the fourth year from the date of initial registration. Non-payment of the prescribed fee may lead to the suspension of the registration certificate.

General Obligations and Responsibilities :

Furnish Information : When required, a banker to an issue has to furnish to the SEBI the following information : (a) the number of issues for which he was engaged as banker to an issue (b) the number of applications / details of the applications money received (c) the dates on which applications from investors were forwarded to the issuing company / registrar to an issue (d) the dates / amount of refund to the investors.

Books of account/record / documents : A banker to an issue is required maintain books of accounts/ records/ documents for a minimum period of three years in respect of, inter alia, the number of applications received, the names of the investors, the time within which the applications received were forwarded to the issuing company / registrar to the issue and dates and amounts of refund money to investors.

Agreement with issuing companies : Every banker to an issue enters into an agreement with the issuing company. The agreement provides for the number of collection centers at which application/ application money received is forwarded to the registrar for issuance and submission of daily statement by the designated controlling branch of the baker stating the number of applications and the amount of money received from the investor.

Code of Conduct : Every banker to an issue has to abide by a code of conduct. He should observe high standards of integrity and fairness in all his dealings with clients/ investors/ other members of the profession. He should exercise due diligence. A banker to an issue should always endeavor to render the best possible advice to his clients and ensure that all professional dealings are effected in a prompt, efficient and cost-effective manner.

BROKERS TO THE ISSUE

Brokers are persons mainly concerned with the procurement of subscription to the issue from the prospective investors. The appointment of brokers is not compulsory and the companies are free to appoint any number of brokers. The managers to the issue and the official brokers organize the preliminary distribution of securities and procure direct subscription from as large or as wide a circle of investors as possible. A copy of the consent letter from all the brokers to the issue, should be filed with the prospectus to the ROC.

The brokerage applicable to all types of public issue of industrial securities is fixed at 1.5%, whether the issue is underwritten or not. The listed companies are allowed to pay a brokerage on private placement of capital at a maximum rate of 0.5%. Brokerage is not allowed in respect of promoters' quota including the amounts taken up by the directors, their friends and employees, and in respect of the rights issues taken by or renounced by the existing shareholders. Brokerage is not payable when the applications are made by the institutions/ bankers against their underwriting commitments or on the amounts devolving on them as underwriters consequent to the under subscription of the issues.

REGISTRARS TO AN ISSUE AND SHARE TRANSFER AGENTS

The registrars to an issue, as an intermediary in the primary market, carry on activities such as collecting applications from the investors, keeping a proper record of applications and money received from the investors or paid to the sellers of securities and assisting companies in determining the basis of allotment of securities in consultation with the stock exchanges, finalizing the allotment of securities and processing / dispatching allotment letters, refund orders, certificates and other related documents in respect of the issue of capital.

To carry on their business, the registrars must be registered with the SEBI. They are divided into two categories : (a) Category I, to carry on the activities as registrar to an issue and share transfer agent; (b) Category II, to carry on the activity either as registrar or as a share transfer agent. Category I registrars mush have minimum net worth of Rs. 6 lakhs and Category II, Rs. 3. Category I is required to pay a initial registration fee of Rs. 50,000 and renewal fee of Rs.40,000 every three years, where as Category II is required to pay Rs.30,000 and Rs. 25,000 respectively.

Code of Conduct : The registrars to an issue and the share transfer agents have to maintain high standards of integrity and fairness in all dealings with their clients and other registrars to the issue and share transfer agents in the conduct of the business.
They should endeavor to ensure that (a) enquiries from investors are adequately dealt with, and (b) adequate steps are taken for proper allotment of securities and refund of application money without delay and as per law. Also, they should not generally and particularly in respect of any dealings in securities to be a party to (a) creation of false market, (b) price rigging or manipulation (c) passing of unpublished price sensitive information to brokers, members of stock exchanges and other intermediaries in the securities market or take any other action which is not in the interest of the investors and (d) no registrar to an issue, share transfer agent or any of its directors, partners or managers managing all the affairs of the business is either on their respective

accounts, or though their respective accounts, or through their associates or family members, relatives or friends indulges in any insider trading.

DEBENTURE TRUSTEES

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company. To act as a debenture trustee a certificate from the SEBI is necessary. Only scheduled commercial banks, PFIs, Insurance companies and companies are entitled to act as a debenture trustees. The certificate of registration is granted to suitable applicants with adequate infrastructure, qualified manpower and requisite funds. Registration fee is Rs. 5 lakh and renewal fee is Rs. 2.5 lakh every three years.

Responsibilities and obligations : Before the issue of debentures for subscription, the consent in writing to the issuing company to act as a debenture trustee is obligatory. He has to accept the trust deed which contains matters pertaining to the different aspects of the debenture issue.

Duties : The main duties of a debenture trustee include the following :

(i) Call for periodical report from the company.
(ii) Inspection of books of accounts, records, registration of the company and the trust property to the extent necessary for discharging claims.
(iii) Take possession of trust property, in accordance with the provisions of the trust deed.
(iv) Enforce security in the interest of the debenture holders.
(v) Carry out all the necessary acts for the protection of the debenture holders and to the needful to resolve their grievances.
(vi) Ensure refund of money in accordance with the Companies Act and the stock exchange listing agreement.
(vii) Exercise due diligence to ascertain the availability of the assets of the company by way of security as well as their adequacy / sufficiency to discharge claims when they become due.
(viii) Take appropriate measure to protect the interest of the debenture holders as soon as any breach of trust deed/ law comes to notice.
(ix) Ascertain the conversion / redemption of debentures in accordance with the provisions / conditions under which they were offered to the holders.
(x) Inform the SEBI immediately of any breach of trust deed / provisions of law.

In addition, it is also the duty of trustees to call or ask the company to call a meeting of the debenture holders on a requisition in writing signed by debenture holders, holding at least one-tenth of the outstanding amount, or on the happening of an event which amounts to a default or which, in his opinion, affects their interest.

PORTFOLIO MANAGERS

Portfolio manager are defined as persons who in pursuance of a contract with clients, advise, direct, undertake on their behalf the management/ administration of portfolio

of securities/ funds of clients. The term portfolio means the total holdings of securities belonging to any person. The portfolio management can be (i) Discretionary or (ii) Non-discretionary. The first type of portfolio management permits the exercise of discretion in regard to investment / management of the portfolio of the securities / funds. In order to carry on portfolio services, a certificate of registration from SEBI is mandatory.

The certificate of registration for portfolio management services is granted to eligible applicants on payment of Rs.5 lakh as registration fee. Renewal may be granted by SEBI on payment of Rs. 2.5 lakh as renewal fee (every three years).
Contract with clients : Every portfolio manager is required, before taking up an assignment of management of portfolio on behalf of the a client, is enter into an agreement with such clients clearly defining the inter se relationship, and setting out their mutual rights, liabilities and obligations relating to the management of the portfolio of the client. The contract should, inter alia, contains :

(i) The investment objectives and the services to be provided.
(ii) Areas of investment and restrictions, if any, imposed by the client with regards to investment in a particular company or industry.
(iii) Attendant risks involved in the management of portfolio.
(iv) Period of the contract and provisions of early termination, if any.
(v) Amount to be invested.
(vi) Procedure of setting the clients' account including the form of repayment on maturity or early termination of contract.
(vii) Fee payable to the portfolio managers
(viii) Custody of securities.

The funds of all clients must be placed by the portfolio manager in a separate account to be maintained by him in a scheduled commercial bank. He can charge an agreed fee from the clients for rendering portfolio management services without guaranteeing or assuring, either directly or indirectly, any return and such fee should be independent of the returns to the client and should not be on a return sharing basis.
Investment of Clients money : The portfolio manager should not accept money or securities from his clients for less than one year. Any renewal of portfolio fund on the maturity of the initial period is deemed as a fresh placement for a minimum period of one year. The portfolio funds and be withdrawn or taken back by the portfolio clients at his risk before the maturity date of the contract under the following circumstances :

(a) Voluntary or compulsory termination of portfolio management services by the portfolio manager.
(b) Suspension or termination of registration of portfolio manager by the SEBI.
(c) Bankruptcy or liquidation in case the portfolio manager is a body corporate.
(d) Permanent disability, lunacy or insolvency in case the portfolio manager is an individual.

The portfolio manager can invest funds of his clients in money market instruments or as specified in the contract, but not in bill discounting, badla financing or for the purpose of lending or placement with corporate or non-corporate bodies. While dealing with client's money he should not indulge in speculative transactions.

Reports to be furnished to the Clients : The portfolio manager should furnish periodically a report to the client, agreed in the contract, but not exceeding a period of six months containing the following details :

(a) The composition and the value of the portfolio, description of security, number of securities, value of each security held in portfolio, cash balances aggregate value of the portfolio as on the date of report.
(b) Transactions undertaken during the period of report including the date of transaction and details of purchases and sales.
(c) Beneficial interest received during that period in respect of interest, dividend, bonus shares, rights shares and debentures,
(d) Expenses incurred in managing the portfolio of the client and details of risk relating to the securities recommended by the portfolio manager for investment or disinvestments.

So, we discussed so far the intermediaries in security market. Next task of yours would be to submit in writing the latest regulations of SEBI in the regards to various intermediaries.

LESSON 35
MERGERS AND AMALGAMATION : AN INTRODUCTION AND SEBI GUIDELINES

Lesson Objectives: **To understand the process of terms mergers and amalgamation.**

Government and SEBI regulations related to M&A activity.

INTRODUCTION

Following the economic reforms in India in the post – 1991 period, there is a discernible trends among promoters and established corporate groups towards consolidation of market share and diversification into new areas through acquisition / takeover of companies but in a more pronounced manner through mergers / amalgamations. Although the economic considerations in terms of motive and effect of these are similar, the legal procedures involved are different. The merger and amalgamation of corporate constitutes a subject matter of the Companies Act, the courts and law and there are well-laid down procedures for valuation of shares and rights of investors. The acquisition/ takeover bids fall under the purview of SEBI. The terms mergers and amalgamations on the one hand and acquisitions and takeovers on the other are treated here synonymously/ interchangeably. Section one of the chapter covers the framework of mergers/ amalgamations including financial evaluation. The regulatory framework governing acquisition/ takeovers is described in Section two. The main points are summarized in Section three.

MERGERS / AMALGAMATIONS

The terms merger and amalgamation are used interchangeably as a form of business organization to seek external growth of business. A merger is a combination of two or more firms in which only one firm wo0uld survive and the other would cease to exist, its assets / liabilities being taken over by the surviving firm. An amalgamation is an arrangement in which the assets / liabilities being taken over by the surviving firm. An amalgamation is an arrangement in which the assets / liabilities of two or more firms become vested in another firm. As a legal process, it involves joining of two or more firms to form a new entity or absorption of one/ more firms with another. The outcome of this arrangement is that the amalgamating firm is dissolved / wound-up and loses its identing and its shareholders become shareholders of the amalgamated firm. Although the merger / amalgamation of firms in India is governed by the provisions of the companies Act, 1956, it does not define these terms. The Income Tax Act, 1961, stipulates two pre-requisites for any amalgamation through which the amalgamated company seeks to avail the benefits of set-off / carry forward of losses and unabsorbed depreciation of the amalgamating company against its future profits under Section 72-A, namely,

(i) all the property and liabilities of the amalgamated company / companies immediately before amalgamation should vest with / become the liabilities of the amalgamated company and

(ii) the shareholders other than the amalgamated company / its subsidiary(ies) holding at least 90 percent value of shares / voting power in the amalgamating company should become shareholders of the amalgamated company by virtue of amalgamation. The scheme of merger, income tax implications of amalgamation and financial evaluation are discussed in this section.

Scheme of Merger / Amalgamation

Wherever two/ more companies agree to merge with each other, they have to prepare a scheme of amalgamation. The acquiring company should prepare the scheme in consultation with its merchant banker(s) / financial consultants. The main contents of a model scheme, inter-alia, are as listed below.

- Description of the transfer and the transferee company and the business of the transferor.
- Their authorized, issued and subscribed / paid –up capital.
- Basis of scheme : Main terms of the scheme in self-contained paragraphs on the recommendation of valuation report, covering transfer of assets / liabilities, transfer date, reduction or consolidation of capital, application to financial institutions as lead institution for permission and so on.
- Change of name, object clause and accounting year.
- Protection of employment.
- Dividend position and prospects.
- Management : Board of directors, their number and participation of transferee company's directors on the board.
- Application under section 291 and 394 of the Companies Act, 1956, to obtain Higher Court's approval.
- Expenses of amalgamation.
- Conditions of the scheme to become effective and operative, effective date of amalgamation.

The basis of merger / amalgamation in the scheme should be the reports of the valuers of assets of both the merger partner companies. The scheme should be prepared on the basis of the valuer's report, reports of chartered accountants engaged for financial analysis and fixation of exchange ratio, report of auditors and audited accounts of both the companies prepared up to the appointed date. It should be ensured that the scheme is just and equitable to the shareholders, employees of each of the amalgamating company and to the public.

Essential Features of Scheme of Amalgamation : The essential features r pre-requisites for any scheme of amalgamation are as enumerated below.

Determination of Transfer Date (Appointed Date) : This involves fixing of the cut-off date from which all properties, movable as well as immovable and rights attached thereto are sought to be transferred from amalgamating company to the amalgamated company. This date is known as transfer date or the appointed date and is normally

the first day of the financial year preceding the financial year for which the audited accounts are available with the company.
Determination of Effective Date by when all the required approvals under various statutes, viz, the Companies Act 1956. The Companies (Court) Rules 1959, Income Tax Act, 1961. Sick Industrial Companies (Special Provisions) Act, 1985, would be obtained and the transfer and vesting of the undertaking of amalgamating company with the amalgamated company would take effect. This date is called effective date. A scheme of amalgamation normally should also contain conditions to be satisfied for the scheme to become effective.

The effective date is important for income tax purposes the Companies Act does not provide for such a date but it is a practical necessity so that a court passing an order under Section 394(2) dealing with vesting of properties in the transferee company has before it a meaningful date contained in the scheme serving the purpose and in the contemplation of the applicant companies who are free to choose any date which will be binding one. While sanctioning the scheme the court also approves this date. The effective date may be either retrospective or prospective with reference to the application to the court. The effect of the requirement is that a mere order for the transfer of the properties / assets and liabilities to the transferee company would cause the vesting only from the date of that order. For tax considerations, the mention in the order of the date of vesting is of material consequences.

i. The scheme should state clearly the arrangements with secured and unsecured creditors including the debenture – holders.
ii. It should also state the exchange ratio, at which the shareholders of the amalgamating company would be offered shares in the amalgamated company. The ratio has to be worked out based on the valuation of shares of the respective companies as per the accepted methods of valuation, guidelines and the audited accounts of the company.
iii. The scheme should also provide for transfer of whole or part of the undertaking to the amalgamated company, continuation of level proceedings between the amalgamating and the amalgamated companies, absorption of employees of the amalgamating company, obtaining the consent of dissenting shareholders and so on.

Approvals for the Scheme The scheme of merger / amalgamation is governed by the provisions of Section 391-394 of the Companies Act. The legal process requires approval to the schemes as detailed below.
Approvals from Shareholders In terms of Section 391, shareholders of both the amalgamating and the amalgamated companies should hold their respective meetings under the directions of the respective high courts and consider the scheme of amalgamation. A separate meeting of both preference and equity share holders should be convened for this purpose. further, in terms of Section 81(1A), the shareholders of the amalgamated company are required to pass a special resolution for issue of shares to the shareholders of the amalgamating company in terms of the scheme of amalgamation.

Approval from Creditors / Financial Institutions / Banks Approvals are required from the creditors, banks and financial institutions to the scheme of amalgamation in terms

of their respective agreements / arrangements with each of the amalgamating and the amalgamated companies as also under Section 391.

Approval from Respective High Court(s) Approvals of the respective high court(s) in terms of Section 391-394, confirming the scheme of amalgamation are required. The courts issue orders for dissolving the amalgamating company without winding-up on receipt of the reports from the official liquidator and the regional director, Company Law Board, that the affairs of the amalgamating company have not been conducted in a manner prejudicial to the interests of its members or to public interests.
Now let us discuss step-wise procedure for amalgamation.

Object Clause The first step is to examine the objects clauses of the memorandum of association of the transferor and the transferee companies so as to ascertain whether the power of amalgamation exists or not. The objects clause of transferee company should allow for carrying on the business of the transferor company. If it is not so, it is necessary to amend the objects clause. Similarly, it should be ascertained whether the authorized capital of the transferee company would be sufficient after the merger / amalgamation. If is not so, this clause should also be amended. Suitable provisions for these could be incorporated in the scheme itself.

Preparation of a scheme of amalgamation on the lines explained earlier.
Meetings / Information

(i) Holding of meeting of the board of directors of both the transferor and the transferee companies (a) to decide the appointed date and the effective date, (b) to approve the scheme of amalgamation and exchange ratio and (c) to authorize directors / officers to make applications to the appropriate high court for necessary action
(ii) Inform the stock exchanges concerned about the proposed amalgamation immediately after the board meetings.
(iii) The shareholders and other members of the companies should also be informed through press release.
(iv) The transferor the and transferee companies should inform the financial institutions, bankers / debenture- trustees at least 45 days before the board meeting so that their approval is available to the proposed amalgamation at the time of board meeting.

Application for Amalgamation An application for amalgamation can be submitted by the company, members or even any of the creditors. A member, in this context means any person who has agreed to be a member and whose name appears on the register of members. A creditor includes all persons having pecuniary claims against the company for some amount whether present or future, definite or contingent. Even one member or one such creditor can make an application for amalgamation. Where the application is proposed to be made by the company, only a person authorized by the company in this behalf can make an application for amalgamation. It is, therefore, essential that the company should authorize the director(s) or other officer (s) to make an application to the appropriate high courts and take necessary action as may be required from time to time. The directors can, however, apply for amalgamation only when requisite power appears in the articles of association originally or by way of

amendment. Separate applications under Section 291 are required to be submitted to the appropriate high courts by the amalgamating and the amalgamated companies for the purpose of the respective high courts issuing directions to convene meetings of shareholders separately for preference and equity shareholders to approve the scheme of amalgamation. It is incumbent on both the transferor and the transferee companies to obtain sanction of high courts having jurisdiction over them. However, where both the companies are under the jurisdiction of the same high court, a joint-application may be made. Such an application can be moved even when an order for winding up has been made. However, the transferee company need not obtain approval under Section 391 when the transferor company is a wholly-owned subsidiary of the transferor company.

Procedure for Application to the High Court The procedure for making application to the high court has been laid down under the Companies (Court) Rules, 1959. An application under section 391 (1) for an order convening a meeting of creditors and/or members or any class of them should be by a judge's summons supported by an affidavit. A copy of the proposed compromise or arrangement should be annexed to the affidavit as an exhibit. The summons should be moved *ex parte*. Where the company is not the applicant, a copy of the summons and of the affidavit should be served on the company, or where the company is being wound-up, on its liquidator, not less than 14 days before the date fixed for the hearing of the summons. On receipt of the application by the high court, a hearing takes place in the judge's chamber, and after the hearing the judge may either dismiss the summons or order a meeting of the members or may give such directions as he may think necessary. But it is incumbent on the court to be satisfied that prima facie the scheme is genuine, *banafide* and largely in the interest of company and its members. On being not satisfied with the scheme, the court may not even order the calling of meeting of creditors even if the consent of the creditors has been withheld or *malafide* or arbitrary even if the court considers the scheme reasonable and beneficial to the creditors. The court may dispense with the requirement of convening a meeting where all the members of a particular class have consented to the scheme and have entered into necessary agreement with the transferee company. Having known. Having known the proposed meeting the creditors may also move the court for rejection of the scheme and the court may entertain such an application and after reasonable scrutiny may call off the meeting.

Holding of Meeting The net step is to hold separate meetings of the shareholders and creditors of the company to seek approval to the scheme. The resolution approving the scheme may be passed by voting in person or by proxy as per the directions of the high court. At least three-fourth in value of the members or class of members or creditors must vote in favour of the resolution approving the scheme of amalgamation.
The members and the creditors are required to be classified into different classes for the purpose of convening meetings. This process has to be followed immediately on receipt of application under section 391 (1). If meetings of incorrect classification are convened and objection is taken with regard to any particular creditor of having interest competing with others, the company runs the risk of the scheme being

dismissed. After classification, the court may order convening of the respective meetings of members and/or creditors.

For the purpose of convening meetings the court may give directions as it may deem fit regarding the following :

(i) Fixing the time and place of such meetings(s);
(ii) Determining the class or classes of creditors and/or members have to be held for considering the proposed compromise or arrangement;
(iii) Appointing a chairman or chairmen for the meeting(s) to be held, as the case may be;
(iv) Fixing the quorum and the procedure to be followed at the meeting(s) including voting by proxy;
(v) Determining the values of creditors and/or the members of any class, as the case may be, whose meetings have to be held;
(vi) Notice to be given of the meeting(s) and the advertisement of such notice;
(vii) The time within which the chairman of the meeting is to report to the court the results of the meeting; and such other matters as the court may deem necessary.

The notice of the meetings of members and/or creditors, should be:

(a) sent to the members / creditors;
(b) sent to them individually by the chairman appointed for the meeting or if the court so directs, by the company or any other person as the court may direct, by post under certificate of posting to the last known address at least 21 clear days before the date of the meeting;
(c) accompanied by a copy of the proposed scheme of compromise or arrangement and of the statement required to be furnished under section 393 and also a form of proxy.

The approval of the registrar of the appropriate high court should be obtained in respect of notice and explanatory statements, specifying the particulars prescribed under section 393 and in accordance with the directions issued by the court.
The notice of the meeting must be advertised in the prescribed form in such paper(s) as the court may direct, not less than 21 clear days before the date fixed for the meeting. In case of default, the summons should be posted before the court for such orders as it may think fit to make.

Report of Chairman to the Court The chairman of the meeting must within the time fixed by the court or where no time is fixed within 7 days of the date of the meeting, report the result of the meeting to the court. The report should state accurately the number of creditors or class of creditors or the numbers of members or class of members, as the case may be, who were present and who voted at the meeting either in person or by proxy, their individual values and the way the voted.
Presenting Petition Before the Court After the proposed scheme is agreed to with or without modification in terms of section 391(2), the company must within seven days of the filing of the report by the chairman, present a petition to the court for confirmation of the compromise or arrangement. A copy of the petition should also be submitted to the regional director, company law board and others as directed by the court. The court would not sanction a scheme simply because it is recommended by

the board of directors and approved by a statutory majority of the company. The court would have to see itself whether the scheme is reasonable and fair to all parties. A scheme which is proper on the face of it and in respect of which no fraud is alleged would not be rejected unless the objector shows any valid ground against it.

Under Section 394 (A), the court should give notice of every application made to it under Section 391 or 394 to the central government/regional directors of company law board and take into consideration the representations, if any, made to it by the government before passing any order. However, the court is not bound to go by the opinion of the government / regional director as to the matters of public interest; rather it can form its independent opinion over the matte.

Where the company fails to present the petition for confirmation of the proposed scheme, it is open to any creditor or contributory, with the leave of the court, to present the petition and the company would be liable for cost. Where no such petition is presented for confirmation, the report of the chairman as to the result of the meeting must be placed for consideration before the judge for such orders as may be necessary. Such a petition must be moved within 7 days of the filling of the report by the chairman.

Once the scheme has been approved by the members of a company in a duly convened and held meeting, the petition filed for confirmation of the same cannot be withdrawn. The only course of action that may be followed is to appear before the court and raise the objections when the scheme comes up for consideration. In such a case, the scheme may not be sanctioned and the court may order for holding meetings of the members again. However, there is noting to prevent a company from requisitioning a meeting to consider a proposed modification in the scheme.

The court would fix a date for hearing of the petition and a notice of the hearing must be advertised in the same newspapers in which the notice of the meeting was advertised or in such other papers as the court may direct not less than 10 days before the date fixed for the hearing.

The order of the court on the petition confirming the scheme should contain such directions in regard to any matter and such modifications in regard to compromise or arrangement as the judge may think fit to make for the proper working of the compromise or arrangement. The order must direct that a certified copy of the same should be filed with the registrar of companies within 14 days from the date of the order or such other time as may be fixed by the court.

The court while sanctioning the scheme should consider (i) that the provisions of the Act have been complied with; (ii) those who took part in the proceedings at the meetings are representatives of the class to which the meeting belongs and that the majority of them acted *bonafide*; and (iii) having regard to the object, background and other conditions of the scheme, the scheme on the whole is reasonable.

The high court may also direct the official liquidator for submission of reports after scrutiny of the books and papers of the amalgamating company. If the report indicates that the affairs of the company have not been conducted in a manner prejudicial to the interest of the public and the shareholders, the court may issue orders for winding up with dissolution.

Application for Direction If necessary, an application for direction of the court to provide for all or any matters indicated in Section 394(1) These are :

(i) The transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of any transferor company;
(ii) The allotment or appropriation by the transferee company of any shares, debentures, policies, or other like interests in that company which, under the compromise or agreement, are to be allotted or appropriated by that company to or for any person;
(iii) The continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;
(iv) The dissolution, without winding-up, of any transferor company;
(v) The provision to be made for any persons who, within such time and in such manner as the court directs, dissents from the compromise or arrangement; and
(vi) Such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation would be fully and effectively carried out.

The court would pass an order. Alternatively, by adding a suitable prayer in the main application, the court could be requested to give direction in regard to the above. In fact, such a course would provide for expeditious completion of amalgamation formalities.

Certificate A certified copy of the order of the court dissolving the amalgamating company or giving approval to the scheme of merger, should be filed with the Registrar of Companies concerned within 30 days of the date of the court's order.

Court Order A copy of the order of the court should be to attached to the memorandum and articles of association of the transferee company [Section 39 391(4)].

As soon as the scheme of amalgamation has become effective, the members should be intimated through the press. Government authorities, banks, creditors, customers and others should also be informed.

FINANCIAL FRAMEWORK

The financial framework of a merger decision covers three inter-related aspects : (i) determining the value of the amalgamating firm (ii) financing techniques in merger, and (iii) analysis of merger as a capital budgeting decision.

Determining the Firm's Value The first problems in analyzing a potential merger involves determining the value of the acquired firm. The value of a firm depends not only upon its earnings but also upon the operating and financial characteristics of the acquiring firm. It is, therefore, not possible to place a single value for the acquired firm. Instead, a range of values is determined that would be economically justifiable to the prospective acquirer. The final price within this range is negotiated by the two firms. To determine an acceptable price for a firm, a number of factors, quantitative as well as qualitative, are relevant. However, placing a value on qualitative factors such as managerial talent, strong, sales staff, excellent production department, and so on is difficult. Therefore, the focus of determining the firm's value is on several quantitative variables. The quantitative factors relate to (a) the value of the assets and

9b0 the earnings of the firm. Based on the assets values and earnings, these factors include book value, appraisal value, market value and earnings per share.
Book Value The book of a firm is based on the balance sheet value of the owner's equity. It si determined dividing net worth, by the number of equity shares outstanding. The book value, as the basis of determining a firm's value, suffers from a serious limitation as it is based on the historical costs of the assets of the firm.

Historical costs do not bear a relationship either to the value of the firm or to its ability to generate earnings. Nevertheless, it is relevant to the determination of a firm's value for several reasons: (i) it can be used as a starting point to be compared and complemented by other analyses, (ii) in industries where the ability to generate earnings requires large investments in fixed assets, the book value could be critical factor where especially plant and equipment are relatively new, (iii) a study of firm's working capital is particularly appropriate and necessary in mergers involving a business consisting primarily of liquid assets such as financial institutions.

Appraisal Value Appraisal value as another measure of determining a firm's value is acquired from an independent appraisal agency. This value is normally based on the replacement costs of assets. The appraisal value has several merits. In the first place, it is an important factor in special situations such as in financial companies, natural resource enterprises or organisations that have been operating at a loss. For instance, the assets of a financial company largely consist of securities. The value of the individual securities has a direct bearing on the firm's earning capacity. Similarly, a company operating at a loss may only be worth its liquidation value which would approximate the appraisal value. Secondly, the appraisal by independent appraisers may permit the reduction in accounting goodwill by increasing the recognised worth of specific assets. Goodwill results when the purchase price of a firm exceeds the value of the individual assets. Third. appraisal by an independent agency provides a test of the reasonableness of results obtained through methods based upon the going-concern concept. Further. the appraiser may identify strengths and weaknesses that otherwise might not be recognised such as in the valuation of patents, partially completed research and development expenditure. On the other hand, this method of analysis is not adequate by itself since the value of individual assets may have little relation to the firm's over-all ability to generate earnings and thus the going concern value of the firm. In brief, the appraisal value procedure is useful if carried out in conjunction with other evaluation processes. In specific cases, it is an important instrument for valuing a firm.

Market Value The market value as reflected in the stock market quotations comprises another approach for estimating the value of a business. The justification of market value as an approximation of true worth of a firm is derived from the fact that market quotations by and large indicate the consensus of investors as to the firm's earning potentials and the corresponding risk. The market value approach is one of the most widely-used in determining value specially of large listed firms. The market value of a firm is determined by investment as well as speculative factors. This value can change abruptly as a result of change not only in the analytical factors but also purely speculative influences and is subject to market sentiments and personal decisions. Nevertheless, the market value provides a close approximation of the true value of a

firm. In actual practice, a certain percentage premium above the market is often offered as an inducement for the current owners to sell their shares.
Earnings Per Share Yet another basis to place a value on a firm is the earnings per share (EPS). According to this approach, the value of a prospective acquisition is considered to be a function of the impact of the merger on the EPS. In other words, the analysis would focus on whether the acquisition will have a positive impact on the EPS after merger or it will have the effect of diluting it. The future EPS will affect the firm's share prices which is a function of price-earnings (PIE) ratio and EPS.

To summarize the discussion relating to earnings per share approach to determine the value of a firm, when the share exchange ratio is in proportion to the EPS, there is no effect on the EPS of the acquiring! surviving firm as well as the acquired firm (Table 16.1). When, however, the exchange ratio is different, it may result into dilution in the EPS of the acquiring firm (Table 16.2) and accretion in the EPS of the acquired firm. For management of a firm considering to acquire another firm, a merger that results in dilutions in EPS should be avoided. However, the fact that the merger immediately dilutes a firm's current EPS need not necessarily make the transaction undesirable. Such a criterion places undue emphasis upon (he immediate effect of the prospective merger on the EPS. In examining the consequences of merger upon the surviving concern's EPS, the analysis should be extended into future periods and the effect of the expected future growth rate in earnings should also be included in the analysis (Table 16.3).

Financing Techniques in Mergers After the value of a firm has been determined on the basis of the preceding analysis, the next step is the choice of the method of payment to the acquired firm. The choice of financial instruments and techniques in acquiring a firm usually has an effect on the purchasing agreement. The payment may taken the form of either cash or securities, that is, ordinary shares, convertible securities, deferred payment plans and tender-offers.
Ordinary Shares Financing When a company is considering to use common shares to finance a merger, the relative price-earnings (PIE) ratios of two firms are an important consideration. For instance, for a firm having a high PIE ratio, ordinary shares represent an ideal method for financing mergers and acquisitions. Similarly, the ordinary shares are more advantages for both companies when the firm to be acquired has low PIE ratio.

Debt and Preference Shares Financing From the foregoing it is clear that financing of mergers and acquisitions with equity shares is advantageous both to the acquiring firm and the acquired firm when the *PIE* ratio is high. Since, however, some firms may' have a relatively lower *PIE* ratio as also the requirement of some investors might be different, the other types of securities, in conjunction with/in lieu of equity shares may be used for the purpose. In an attempt to tailor a security to the requirement of investors who seek dividend/interest income in contrast to capital appreciation/growth, convertible debentures and preference shares might be used to finance merger. The use of such sources of financing has several advantages. namely,

(i) Potential earning dilution may be partially minimised by issuing a convertible security. For example, suppose the current market price of the shares of an acquiring

company is Rs 50 and the value of the acquired firm is Rs 50,00,000. If the merger proposal is to be financed with equity, 1,00,000 additional shares will be required to be issued. Alternatively, convertible debentures of the face value of Rs 100 with conversion ratio of 1.8, which would imply conversion value of Rs 90 (Rs 50 x 1.8) may be issued. To raise the required Rs 50,00,000, 50,000 debentures convertible into 90,000 equity shares would be issued. Thus, the number of shares to be issued would be reduced by 10,000, thereby reducing the dilution in EPS that could ultimately result, if convertible security in place of equity shares was not resorted to; (ii) A convertible issue might serve the income objective of the shareholders of target firm without changing the dividend policy of the acquiring firm; (iii) Convertible security represents a possible way of lowering the voting power of the target company; (iv) Convertible security may appear more attractive to the acquired firm as it combines the protection of fixed security with the growth potential of ordinary shares.

In brief, fixed income securities are compatible with the needs and purposes of mergers and acquisitions. The need for changing the financing leverage and for a variety of securities is partly resolved by the use of senior securities.
Deferred Payment Plan Under this method, the acquiring firm, besides making initial payment, also undertakes to make additional payment in future years to the target firm in the event of the former is able to increase earnings consequent to merger. Since the future payment is linked to the firm's earnings, this plan is also known as *earn-out* plan. There are several advantages of adopting such a plan to the acquiring firm: (i) It emerges to be an appropriate outlet for adjusting the difference between the amount of shares the acquiring firm is willing to issue and the amount the target firm is agreeable to accept for the business; (ii) In view of the fact that fewer number of shares will be issued at the time of acquisition, the acquiring firm will be able to report higher EPS immediately; (iii) There is built-in cushion/protection to the acquiring firm as the total payment is not made at the time of acquisition; it is contingent to the realisation of the potential projected earnings after merger.

Notwithstanding the above benefits, there are certain problems of this mode of payment. The important ones are: (i) The target firm must be capable of being operated as an autonomous business entity so that its contribution to the total projects may be determined; (ii) There must be freedom of operation to the management of the newly acquired firm; (iii) On the part of the management of the acquiring firm, there must be willing co-operation to work towards the success and growth of the target firm, realising that only by this way the two firms can gain from merger.

There are various types of deferred payment plan in vogue. The arrangement eventually agreed upon depends on the imagination of the management of the two firms involved. One of the often-used plans for the purpose in *Base-period earn-out.* Under this plan the shareholders of the target firm are to receive additional shares for a specified number of future years, if the firm is able to improve its earnings *vis-a-vis* the earnings of the base period (the earnings in the previous year before the acquisition). The amount becoming due for payment in shares in future years will primarily be a function of excess earnings, price earnings ratio and the market price of the share of the acquiring firm. The basis for determining the required number of shares to be issued in as per following equation.

Excess earnings x P / E ratio
Share price (acquiring firm)

Illustration

Company A has purchased company B in the current year. Company B had its base year earnings of Rs 3,00,000. At the time of merger its shareholders received initial payment of 75,000 shares of Company A. The market value of the Company A's share is Rs 30 per share and the PIE ratio is 8. The Projected post merger earnings of Company B for next three years are Rs 3,30,000, Rs 3,90,000, Rs 4,14,000. Assuming no changes in share prices and PIE ratio of Company A, determine the number of shares required to be issued to the shareholders of Company B during three years.

Solution

Number of Shares

Year 1:	Rs 30,000 x 8 / Rs30	= 8,000
Year 2	Rs 90,000 x8 / Rs. 30	= 24,000
Year 3:	Rs 1,14,000 x 8 / Rs. 30	= 30,400

Thus, the shareholders of company B will receive a total of 1,37,400 shares (75,000 initial + 62,400 in subsequent three years).

To conclude, the deferred-plan technique provides a useful means by which the acquiring firm can eliminate part of the guess-work involved in purchasing a firm. In essence, it allows the merging management the privilege of hindsight.

Tender Offer An alternative approach to acquire another firm is the tender offer. A tender offer, as a method of acquiring firms, involves a bid by the acquiring firm for controlling interest in the acquired firm. The essence of this approach is that the purchaser approaches the shareholders of the firm rather than the management to encourage them to sell their shares generally at a premium over the current market price.

Since the tender offer is a direct appeal to the shareholders, prior approval of the management of the target firm is not required. In case, the management of the target firm does not agree with the merger move, a number of defensive tactics can be used to counter tender offers. These defensive tactics include WHITE KNIGHTS and PAC-MANS. A white knight is a company that comes to the rescue of a firm that is being targeted for a take-over. Such a company makes its own tender offer at a higher price. Under Pac-mans form of tender offer the firm under attack becomes the attacker.

As a form of acquiring firms, the tender offer has certain advantages and disadvantages. The disadvantages are: (i) If the target firm's management attempts to block it, the cost of executing offer may increase substantially; (ii) the purchasing company may fail to acquire a sufficient number of shares to meet the I objective of controlling the firm. The major advantages of acquisition through tender offer include: (i) If the offer is not blocked, it may be less expensive than the normal route of acquiring a company. This is so because it permits control by purchasing a smaller proportion of the firm's shares; (ii) The fairness of the I purchase price is not questionable as each shareholder individually agrees to part with his shares at the I negotiated price.

Merger As a Capital Budgeting Decision Like capital budgeting decision, merger decision requires comparison between the expected benefits [measured in terms of the present value of expected benefits/cash inflows (CFAT) from the merger] with the cost of the acquisition of the target firm. The acquisition costs include the payment made to the target firm's shareholders, payment to discharge the external liabilities of the acquired firm less cash proceeds expected to be realised by the acquiring firm from the sale of certain asset(s) of the target firm. The decision criterion is 'to go for the merger' if net present value (NPV) is positive; the decision would be 'against the merger' in the event of the NPV being negative.

LESSON 36
ACQUISITIONS AND TAKEOVERS: AN INTRODUCTION AND SEBI GUIDELINES

Lesson Objectives: **To understand the process of acquisitions and takeovers.**

Government and SEBI regulations related to acquisition and takeovers.

ACQUISITION/TAKEOVERS

Takeover implies acquisition of controlling interest in a company by another company. It does not lead to dissolution of the company whose shares are being l have been acquired. It simply means a change of controlling interest in a company through the acquisition of its shares by another group. The takeovers can assume three forms: (i) negotiated/friendly, (ii) open market/hostile and (iii) bail-out. The first type of takeover is organised by the incumbent management with a view to part with the control of management to another group through negotiation. The terms and conditions of the take-over are mutually settled by both the groups. The hostile takeovers are also referred to as raid on the company. In order to take over the management of, or acquire controlling interest in, the target company, a person/group of persons acquire shares from the open market/financial institutions/mutual funds/willing shareholders at a price higher than the prevailing market price. Such takeovers are hostile to the existing management. When a profit earning company takes over a financially sick company to bail it out, it is known as bail-out takeover. Normally, such takeovers are in pursuance of a scheme of rehabilitation approved by public financial institutions! schedule banks. The take-over bids in respect of purchase price, track record of the acquirer and his financial position are evaluated by a leading financial institution. The corporate takeovers in the country are governed by the listing agreement with stock exchanges and the SEBI code. The main elements of the regulatory framework for takeovers and hostile take-over strategies and defensive strategies are briefly described in this Section.

Listing Agreement The takeover of companies listed on the stock exchanges is regulated by clause 40-A and 40-B of the listing agreement. The clause 40-A deals with substantial acquisition of securities and clause 40-B details the requirements to be met when a takeover offer is made to a company either voluntarily or otherwise.
Substantial Acquisition of Securities The company agrees that the following would also be the conditions for continued listing:

(a) When a person acquires or agrees to acquire any securities in the company and when the total nominal value of such securities so acquired or agreed to be acquired together with the total nominal value of the securities already held by such person, exceeds or would exceed in the aggregate 5 per cent of the voting capital of the company, the stock exchange should be notified within 2 days of such acquisition or such agreement for acquisition, by the company, by the authorised intermediary and also by the acquirer.

(b) When any person holds securities which in the aggregate carry less than 10 per cent of the voting rights in the company, he can not acquire any securities which, when aggregated with the securities already held by him, would carry 10 per cent or more of the voting rights unless he notifies the stock exchange and fulfills the condition~ specified in clause 40-B, unless the SEBI has specifically granted exemption.
(c) The company should notify the stock exchange within 7 days about any information which has an effect on its assets and liabilities or financial position or on the general course of its business leading to substantial movements in the price of the securities and in particular information about transactions mentioned above.
(d) The above conditions are not applicable to an acquisition by a person who has announced his firm intention to make an offer to the company and also notified the stock exchange.

Requirements for Takeover Offer The company also agrees that it is a condition for continuous listing that whenever a takeover offer is made to, or by it, whether voluntarily or compulsorily, the following requirements would be fulfilled.

1. A public announcement of a takeover offer would be made both by the offeror company and the offeree company when (a) any person in his own name or in the name of any other person acquires, whether by a series of transactions over a period of time or otherwise, securities which when aggregated with securities already held or acquired by such person would carry 10 per cent or more of the total voting rights of the offeree company; or (b) secure the control of management of a company, by acquiring or agreeing to acquire, irrespective of the percentage of the voting capital, the securities of the directors or other members, who by virtue of their holdings of securities together with the holdings of their relatives, nominees, family interest and group control or manage the company,
2. If the offer is made by a person other than the ultimate offerer, the identity of such other person would be disclosed at the outset in the public announcement as also in the notification to the stock exchange.
3. The offer should be placed, in the first instance before the board of directors of the offeree company containing the following particulars: (a) detailed terms of offer, (b) identity of the offerer, (c) details of offerer's existing holding in the offeree company, (d) all conditions to which the offer is subject, and (e) confirmation by the offerer that resources available to the offeror are sufficient to satisfy full acceptance of the offer.
4. All the above information would be made equally available to all the shareholders both of the offeror company and the offeree company at the same time and in the same manner. along with copies of all documents and announcements bearing an offer which would simultaneously be lodged with SEBI.
5. (a) The offer document addressed by the offeror company to the offeree company should contain the following information: (i) financial information of the offeror company; (ii) intention of the offeror company regarding continuation of the business of the offeree company; (iii) intention of the offeror company regarding any major changes to be introduced in the business

of the offeree company; (iv) long term commercial justification of the offeror company for the proposed offer; and (v) such other details as may be prescribed by SEBI and (b) The offer must state the extent to which its directors have an interest in the bid.

6. Dealings in any securities by the offeror company or the offeree company and by any of their associates for and on behalf of discretionary investment clients, during an offer period, should be notified to the stock exchange by the respective company.
7. The offeror company should, either before or immediately after making the offer to the offeree company, make an offer to the remaining members of the offeree company to purchase their securities at a price not lower than either the average of the highest weekly prices during the immediately preceding 26 weeks from the public announcement of the takeover offer or the negotiated price, whichever is higher. The price would be paid in cash only.
8. The offer to the remaining shareholders of the transferee company would be to acquire from them an aggregate minimum of 20 per cent of the total shares of that company. Such offer, however, should not result in the public shareholdings being reduced to less than 20 per cent of the voting capital of the company, subject to (9) below.
9. From each of the shareholders accepting such offer, the acquirer should acquire his full holding up to 100 shares of the face value of Rs 10 each or up to 10 shares if the face value is Rs 100.
10. 10. When the directors of an offeree company sell shares to a purchaser as result of which the purchaser is required to make an offer, the directors should ensure as a condition of the sale, the purchaser undertakes to fulfill his obligations.
11. The board of directors of the offeree company should not, without the approval of the shareholders in general meeting (a) issue any authorised but un-issued shares; (b) issue any securities carrying rights of conversion, into or subscription for, shares; or (c) sell, dispose off or acquire assets of a substantial amount.
12. The provisions of clause 40-A and clause 40-B, do not apply to acquisition of securities in the company of (i) Unit Trust of India, (ii) SEBI Capital Markets Ltd., (iii) Canbank Financial Services Ltd., (iv) LIC Mutual Funds, (v) such other agencies or mutual funds as may be specified by SEBI from time to time, (vi) in pursuance to orders of amalgamations, mergers and acquisitions passed by the court under sections 391 and 394 of the Companies Act, (vii) in pursuance to orders passed by the BIFR under Sick Industrial Companies (Special Provisions) Act, 1985.
13. The provisions contained in this clause are without prejudice to the approval required to be obtained under the Companies Act, MRTP Act and Foreign Exchange (Regulation) Act, 1973.

Complying with the provisions of clause 40-B could be avoided in respect of an intended takeover if SEBI has granted exemption vide proviso to clause 40-A(b) of the standard listing agreement.

SEBI Substantial Acquisition of Shares and Take-over Code A take-over bid is generally understood to imply the acquisition of shares carrying voting rights in a

company in a direct or indirect manner with a view to gaining control over the management of the company. Such takeovers could take place through a process of friendly negotiation or in a hostile manner in which the existing management resists the change in control. Both the substantial acquisition of shares and change in the control of a listed company are covered by takeover bids.
Disclosure of Shareholding and Control in Listed Companies : Acquisition of 5 per cent Shares/Voting Rights Any acquirer of shares/voting rights together with the existing holdings in excess of 5 per cent in a company in pursuance of a public issue or by one/more transaction(s) or in any other manner is required to disclose to the concerned company the aggregate of his holdings/voting rights within four working days of the receipt of intimation of allotment/acquisition of shares. The aggregate number of shares held by each such person must be disclosed within seven days of the receipt of information to the concerned stock exchange by the concerned listed company.

According to the SEBI code, Acquirer means any person who directly, or indirectly acquires or agrees to acquire shares/voting rights or control over the target company either by himself or with any person acting in concert with him. Target company means the company whose shares/voting rights/control is being acquired.
The term control includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by persons) acting individually or in concert directly or indirectly including by virtue of their shareholding or management rights or shareholders/voting agreements or in any other form.

Person(s) Acting in Concert comprises persons who pursuant to an agreement/ understanding, formal/informal, directly/indirectly cooperate for common objective/ purpose of substantial acquisition of shares/ voting rights/gaining control over the target company. They should be grouped in such a manner in the same group/category that they bear such relationship amongst themselves as could justify a presumption in the normal course that they are acting in concert. Unless the contrary is established, the following are deemed to be persons acting in concert with other persons in the same category: (i) a company, its holding/subsidiary company, company under the same management either individually or together with each other; (ii) a company with any of its directors/any person entrusted with the management of the funds of the company; (iii) directors and their associates, (iv) mutual funds with sponsors and/or trustee and/or asset management company; venture capital funds with their sponsors; (v) FIIs with sub-account(s); (vi) merchant bankers with their client(s) as acquirer; (vii) portfolio managers with their client(s) as acquirer; (viii) banks with financial advisers including stock brokers of the acquirer or to any holding/subsidiary/relative of the acquirer company. However, it is not applicable to a bank whose sole relationship with an acquirer/any company which is holding/subsidiary company of the acquirer or with a relative of the acquirer, is by way of providing normal commercial banking service/activities in connection with the offer such as confirming availability of funds, handling of acceptances and other registration work, for instance; and (ix) any investment company in cases where such companies are used as vehicles to make substantial acquisition of shares/voting rights in a company with any person who has an interest as director/fund manager/trustee/shareholder having not less than 2 per cent of the paid-up capital of

that company/with any other investment company in which such person and/or his associate holds not less than 2 per cent of the paid-up capital of the latter company.

Shares include any security which entitles the holders to receive shares with voting rights at a future data. However, mere acquisition of such a security would not trigger the code at the point of acquisition before voting rights are acquired but only at the point when the securities are converted into shares with voting rights.
Promoter means (1) the person/persons who are in control of the company/named in any offer document as promoters; (2) a relative of the promoter as defined by the Companies Act, i.e., any spouse/parent/ brother/children of the person or of the spouse; (3) in case the promoter is a corporate, (i) its subsidiary/ holding company, (ii) any company in which the promoter holds 10 per cent or more of the equity capital! which holds 10 per cent or more of the equity capital of the promoters, (iii) any corporate body in which a group of individuals/corporate bodies/their combinations who hold 20 per cent or more of the equity capital of the promoter; and (4) where the promoter is an individual, (i) any company in which 10 per cent of or more of the share capital is held by the promoter/a relative of the promoter/a firm or Hindu Undivided Family (HUF) in which the promoter or his relative is a partner/co-partner/their combination, (ii) any company which is a company specified in (i) above, holds 10 per cent or more of the share capital, (iii) any HUF/firm in which the aggregate share of the promoter and his relatives is not less than 10 per cent of the total.

Continual Disclosure All persons holding more than 15 per cent shares/voting rights with shares/ voting rights already held, if any, have to disclose within 21 days from the end of each financial year in respect of their holdings as on March 31 to the company concerned. The promoters/persons having control over a company should disclose to the company within 21 days from the end of the financial year ending March 31 as well as the record date of the company for the purpose of declaration of dividend, the number and percentage of shares/voting rights held by him and by the persons acting in concert with them in that company. Within 30 days from the end of the financial year ending March 31 as well as the record date of the company for the purpose of declaration of dividend, all listed companies have to make yearly disclosures to the concerned stock exchange the changes in respect of the holdings of the such persons/promoters as on March 31. However, if no such report is received, the presumption would be that there is no change to warrant reporting.

Power to Call for Information The stock exchange and the concerned companies would have to furnish to the SEBI information regarding disclosure of shareholding and control as and when required.
Power to Remove Difficulties In order to remove any difficulties in the interpretation/application of the provisions of this code, SEBI has powers to issue directions through guidance notes/circulars which would be binding on the acquirers, target company, shareholders and merchant bankers.
Substantial Acquisition of Shares/Voting Rights/Control The SEBI code applies to (1) substantial acquisition of shares/voting rights in, and acquisition of control over, a listed company and (2) acquisition of 15 per cent or more shares/voting rights of a company. However, they are inapplicable in the following cases:

(a) Allotment in public issue. Firm allotment would be exempt only if full disclosure about the identity of the acquirer acquiring such number of shares as would increase his holding to 5 per cent or more of the post-issue capital, the purpose of acquisition, consequential change in board of directors of the company or change in control over the company/voting rights and shareholding pattern of the company, are given in the prospectus.

(b) Allotment in rights issues to the extent of his entitlement and additional allotment within the limit of the acquisition permitted by the regulations in any period of 12 months and additional allotment to person(s) currently in control of the company provided he had disclosed in the letter of offer that he intends to take up additional shares if the issue is under-subscribed. However, this exemption would not be available in case the acquisition results in the change of control of management.

(c) Preferential allotment covered under Section 8l(A) of the Companies Act, in which case full disclosures of the identity of the class of the proposed allottee(s) is made. If any of the allottee(s) is to be allotted such number of shares as would increase his holding to 5 per cent or more of the post-issued capital, the price at which the allotment is proposed, the identity of such person(s), the purpose of such allotment, consequential changes in the board of directors or change in control over the company or voting rights and the shareholding pattern are disclosed in the notice of the annual general meeting called for the purpose of consideration of the preferential allotment. However, the exemption would be applicable only if such acquisition does not result in change in the control of the company. Moreover, the board resolution in respect of the proposed preferential allotment is sent to all the stock exchanges on which the shares of the company are listed for being displayed on the notice board.

(d) Allotment in pursuance of any underwriting arrangement.

(e) *Interse* transfer of shares amongst (i) group companies, within the definition of group in the MRTP Act; (ii) relatives, (iii) (1) Indian promoters and foreign collaborators who are shareholders, (2) promoters provided the transferor(s) as well as the transferee(s) have been holding individually or collectively not less than 5 per cent shares in the company for a period of at least 3 years prior to the proposed acquisition.

(f) Acquisition of shares in the ordinary course of business by (i) a register stock-broker on behalf of his clients, (ii) by public financial institution on their own account; and (iii) by banks and public financial institutions as pledges.

(g) Acquisition of shares by way of transmission on succession or inheritance.

(h) *Interse* transfer of shares among government companies and statutory corporations.

(i) Transfer of shares from state level financial institution including their subsidiaries to co-promoter(s) of the company pursuant to an agreement between them.

(j) Pursuant to a scheme (i) framed under Sick Industrial Companies Act, (ii) of arrangement/amalgamation/merger/ de-merger under any law/regulation, Indian or foreign.

(k) Acquisition of shares in unlisted companies provided such acquisition/change of control of an unlisted company whether in India or abroad would not result in the acquisition of shares/voting rights/control over a listed company.

(l) Acquisition of shares in the ordinary course of business by a registered market maker of stock exchange in respect of shares for which he is the market maker during the course of market making. These regulations also do not apply to acquisition of global depository receipts (GDRs) and American depository receipts (ADRs) so long as they are not converted into shares carrying voting rights.

(m) Such other cases as may be exempted by SEBI. The acquirer would have to apply together with a fee of Rs 25,000 detailing the proposed acquisition and the grounds for seeking exemption. Within 5 days of the receipt of the application. SEBI would refer it to a Take-over Panel constituted for the purpose consisting of its own officers and majority representation of independent persons. The Panel would within 15 days make recommendations on the basis of which SEBI would pass an appropriate order within 30 days.

In respect of acquisition under clauses (c), (e), (h) and (i), the concerned stock exchanges should, for the information of public, notify the details of the proposed transaction at least 4 working days in advance of the proposed date of acquisition in case acquisition exceeds 5 per cent of the voting share capital of the company. Moreover, in respect of such acquisition under clauses (a), (b), (c), (e) and (i), the acquirer should within 21 days of the date of acquisition submit a report to SEBI together with a fee of Rs.10,000, giving details with supporting documents in case of acquisition which taken together with shares/voting rights held by him/person acting in concert with him would entitle such person to exercise 15 per cent or more of the voting rights in a company.

Acquisition of 15 Per Cent or More Shares/Voting Rights An acquirer who agrees to acquire! acquire shares/voting rights which together with existing holdings by him/person(s) working in concert with him entitle him to exercise 15 per cent or more of the voting rights in a company has to make a public announcement to the effect.
Consolidation of Holdings An acquirer who together with a person acting in concert holds not less than 15 per cent but not more than 75 per cent of the shares/voting rights in a company has to make a public announcement to acquire additional shares/voting rights entitling him to exercise more than 5 per cent of the rights in any period of 12 months. Moreover, an acquirer cannot acquire shares/voting rights which together with the existing holdings, if any, entitle him to exercise more than 75 per cent of the voting rights in a company without making a public announcement. The term acquisition with reference to the substantial acquisition and consolidation of holdings includes both direct in a listed company as well as indirect by virtue of acquisition of holding in companies whether listed/unlisted in India/abroad.

Acquisition of Control Irrespective of whether or not there has been any acquisition of shares/voting rights, no person can acquire control over the target company without making a public announcement. A change in control in pursuance to a resolution of

the shareholders is exempted from this requirement. Where there are two or more persons in control of the target company, the cessor of anyone of them from such control or change in the nature and quantum of control between them would not constitute change in control of management. If the transfer of joint control to sole control is through sale at less than the market value of the shares, the mode of disposal of the outgoing shareholders by a letter of offer or by a block transfer to the existing shareholders in control would be in accordance with a special resolution of the shareholders of the target company. A joint control would not be deemed to be a change in control so long as control is equal to/less than the control exercised by person(s) presently having control over the company.

Appointment of a Merchant Banker Before making any public announcement of offer, the acquirer has to appoint a Category I merchant banker who should not be a group company/associate of the acquirer or the target company.
Timing of Public Announcement of Offer The merchant banker would make the public announcement not later than four working days of the agreement or the decision to acquire shares/voting rights in excess of the specified percentages. In case of an acquirer of securities including *GDRs/*ADRs which would entitle him to voting rights at a later date, the public announcement should be made not later than four working days before conversion/exercise of option as the case may be leading to acquisition of shares with voting rights exceeding the threshold limit. The public announcement by the merchant banker in case of acquiring control has to be made not later than four working days of the decision to change control.

Public Announcement of Offer should be made in all editions of one English national daily with wide circulation, one Hindi national daily with wide circulation and a regional language daily having circulation at the place of the registered office of the target company and the stock exchange where the shares are most frequently traded. Before its issuance, a copy of the announcement must be submitted to SEBI at least two days in advance. Simultaneous with the release to the press, the public announcement should be sent to the concerned stock exchanges for notification on the notice boards and to the target company to be placed before the board of directors. The offer would be deemed to have been made on the date of its appearance in the newspapers.

Contents of the Public Announcement Offer The public announcement should contain the following particulars, namely :

(i) the existing paid-up share capital of the target company, giving break-up of the number of fully paid-up and partly paid-up shares;
(ii) the total number and percentage of shares proposed to be acquired from the public, subject to the specified minimum;
(iii) the minimum offer price for each fully paid-up or partly paid-up share;
(iv) the identity of the acquirer(s) and in case the acquirer is a company or companies, the identity of the promoters and, or the persons having control over such company(ies) and the group, if any, to which the company(ies) belong;
(v) the existing holding, if any, of the acquirer in the shares of the target company, including holdings of persons acting in concert with him;

(vi) salient features of the agreement, if any, such as the date, the name of the seller, the price at which the shares are being acquired, the manner of payment of the consideration and the number and percentage of shares in respect of which the acquirer has entered into the agreement to acquire the shares or the consideration, monetary or otherwise, for the acquisition of control over the target company, as the case may be;

(vii) the highest and the average price paid by the acquirer or persons acting in concert with him for acquisition: if any, of shares of the target company made by him during the 12 months period prior to the date of public announcement;

(viii) object and purpose of acquisition of the shares; the future plans of the acquirer, if any, for the target company including whether he proposes to strip/dispose off or otherwise encumber any of the assets of the target company during the succeeding two years except in the ordinary course of business of the target company. Where the public announcement sets out the future plans, it should also be stated how he proposed to implement it;

(ix) the 'specified date';

(x) the date by which individual letters of offer would be posted to the shareholders;

(xi) the date of opening and closure of the offer and the manner in which arid the date by which the acceptance or rejection of the offer should be communicated to the shareholders;

(xii) the date by which the shares in respect of which the offer is accepted would be acquired against payment of consideration;

(xiii) statement to the effect that firm arrangement for financial resources required to implement the offer is already in place including the details regarding the source of funds;

(xiv) provision for acceptance of the offer by person(s) who own the shares but are not the registered holders of such shares;

(xv) the statutory approvals, if any, required to be obtained for the purpose of acquiring the shares under the Companies Act, the Monopolies and Restrictive Trade Practices Act, 1969, The Foreign Exchange Regulation Act, 1973, and/or any other applicable laws;

(xvi) whether the offer is subject to a minimum level of acceptances from the shareholders;

(xvii) mode of payment of consideration;

(xviii) approval of banks and financial institutions and

(xix) such other information as is essential for the shareholders to make an informed decision in regard to the offer.

Brochures and Advertisement Material The public announcement of the offer/any other advertisement, circular, brochure, publicity material/letter of offer issued in relation to the acquisition of the shares should not contain any misleading information.

Submission of Letter of Offer to SEBI The acquirer should through its merchant banker file with SEBI the draft of the letter of offer containing the specified disclosures together with a fee of Rs 50,000 within 14 days from the date of public announcement. The offer letter is required to be dispatched to the shareholders not

earlier than 21 days from its submission to SEBI. If within 21 days, SEBI indicates any changes, the merchant banker-acquirer would have. to carry them out before the dispatch of the offer letter to the shareholders. If no comments are communicated by the SEBI within 21 days, the offer document may be circulated to the shareholders.
Specified Date The public announcement should specify a date of for the purpose of determining the names of shareholders to whom the letter of offer would be sent. The specified date cannot be later than the thirtieth (30th) day from the date of public announcement.

Minimum Offer Price at which the share: would be acquired would be payable at the option of the shareholders (a) in cash, (b) by exchange and/or transfer of shares of the acquirer if it is a listed company/ body corporate, (c) by exchange and/or transfer of secured instruments with a minimum of A grade rating from a credit rating agency, (d) a combination of all the three. The minimum offer price should be the highest of (i) the negotiated price under the agreement, (H) the highest price paid by the acquirer/person acting in concert with him for acquisition including by way of allotment in a public/rights issue, if any, during the 26 weeks prior to the date of the public announcement, (Hi) the price paid by the acquirer under a preferential allotment made to him/persons acting in concert with him at any time during the 12 month period up to the date of the closure of the offer, (iv) the average of the quoted weekly high and low of the closing prices of the shares of the target company on the stock exchange where its shares are most frequently traded during the 26 weeks preceding the date of public announcement. If the share of the target company are not frequently traded, the offer price should be determined in consultation with the merchant banker based on the following factors, disclosing in the offer document the basis of determination of the price: alternatives (i) to (Hi) above and other parameters including return on net worth, book value of the shares of the target company, earnings per share, *PIE* multiple *vis-a-vis* the industry average. Shares would be deemed to be frequently traded if, on the stock exchange, the annualised trading turnover in that share during the preceding six calendar months prior to the month in which the public announcement is made, is less than 2 per cent (by number of shares) of the listed shares. For this purpose, the weighted average number of shares listed during the relevant 6 months may be taken. In case of shares which have been listed within 6 months preceding the public announcement, the trading turnover may be annualised with reference to the actual number of days for which the shares have been listed. Where the acquirer acquires after the date of public announcement shares in the open market/through negotiation/otherwise at a price higher than the minimum offer price stated in the letter of offer, such a higher price would have to be paid for all acceptances received under the offer. However, such acquisition should be made by the acquirer during the last 7 working days prior to the closure of the offer. In case the acquirer offers in lieu of cash payment its shares/secured instruments, their value would be determined on the basis specified above in respect of the target company to the extent possible as duly certified by an independent category I merchant banker other than the manager(s) to the offer or an independent chartered accountant of 10 years standing. The letter of offer must contain justification on the basis of which the price has been determined.

The highest/average price may be adjusted for quotations, if any, on cum-rights or cum-bonus basis during the period. The average price should be calculated with reference to 26 weeks period preceding the date of board resolution which authorised the firm/preferential allotment. In case of option to shareholders to accept payment either in cash or by way of exchange of security, the pricing for the cash offer could be different from that of a share exchange offer/offer for exchange with secured instruments and suitable justification for the differential pricing should be given in the offer document. Where the offer is subject to a minimum level of acceptance, should the offer not receive full acceptance, the acquirer may indicate a lower price for the minimum acceptance of 20 per cent.

Minimum Number of Shares to be Acquired The public offer should be made to the shareholders of the target company to acquire an aggregate minimum of 20 per cent of the voting capital of the company. In case of the open offer consequent upon consolidation of holdings with voting rights exceeding 51 per cent, the public offer should be for such percentage of the voting capital of the company as may be decided by the acquirer. If the offer is conditional upon minimum level of acceptances from the shareholders, the stipulation of the minimum 20 per cent would not apply provided the acquirer deposits a sum of 50 per cent of the consideration payable under the public offer in the escrow account. If the public offer results in the public shareholding being reduced to 10 per cent or less or if the public offer pertains to a company with public shareholding of less than 10 per cent of the voting capital of the company, the acquirer should within a period of 3 months from the date of closure of the public offer make an offer to buyout the outstanding shares remaining with the shareholders at the same offer price which may result in de-listing of the target company or alternatively undertake to disinvest through offer for sale/fresh issue of capital to the public which should open within a period of six months from the date of closure of the public offer such number of shares as would bring the public shareholding to a minimum level of which would satisfy the listing requirement of 25 per cent or more of the voting capital of the target company. The letter of offer should state clearly the option available to the acquirer in this regard. For the purpose of computing these percentages, the voting rights as at the expiration of 30 days after the closure of the public offer should be reckoned. Public shareholding means shareholding in the hands of person(s) other than the acquirer and persons acting in concert with him.

Where the number of shares offered for sale by the shareholders are more than the share agreed to be acquired by the person making the offer, such persons should accept the offers received from the shareholders on a proportional basis in consultation with the merchant banker, taking care to ensure that the basis of acceptance is decided in a fair and equitable' manner and does not result in non-marketable lots. The acquisition of shares from a shareholder should not be less than the minimum marketable lot or the entire holding if it is less than marketable lot.
General Obligations of the Acquirer The public announcement of offer to acquire the shares of the target company should be made only when the acquirer is able to implement the offer.

Within 14 days of the public announcement of the offer, the acquirer must send a copy of the draft letter of offer to the target company at its registered office address, for being placed before the board of directors and to all the stock exchanges where the shares of the company are listed.

The acquirer must ensure that the letter of offer is sent to all the shareholders (including non-resident Indians) of the target company, whose names appear on the register of members of the company as on the specified date mentioned in the public announcement, so as to reach them within 45 days from the date of public announcement. The letter of offer should also be sent to the custodians of the GDRs/ ADRs holders, holders of warrants/convertibles issued pursuant to a domestic issue when the period for the exercise of the option falls within the offer period. Offer period means the period between the date of public announcement of the first (initial) offer and the date of the closure of offer. Where the public announcement is pursuant to an agreement to acquire shares or control over the target company, the letter of offer should be sent to shareholders other than the parties to the agreement. Persons other than parties to the agreement in the case of negotiated take-over may participate in the open offer.

The date of opening of the offer should be not later than 60th day from the date of public announcement. The offer to acquire shares from the shareholders should remain open for a period of a maximum of 30 days. In case the acquirer is a company, the public announcement of offer, brochure, circular; letter of offer or any other advertisement or publicity material issued to shareholders in connection with the offer must state that the directors accept the responsibility for the information contained in such documents. If any of the directors desires to exempt himself from responsibility for the information in such document, such directors should issue a statement to that effect, together with reasons for such a statement. During the offer period, the acquirer or persons acting in concert with him should not enter the board of directors of the target company. .

Where an offer is made conditional upon minimum level of acceptances, the acquirer or any person acting in concert with him:

(i) should, irrespective of whether or not the offer received in response to the minimum level of acceptances, acquire share from the public to the extent of the minimum percentage specified. However, an acquirer would be exempted if he deposits in the escrow account in cash 50 per cent of the consideration payable under the public offer;

(ii) should not acquire, during the offer period, any shares in the target company, except by way of fresh issue of shares of the target company, as exempted under these regulations;

(iii) should be liable for penalty of forfeiture of entire escrow amount, for non fulfillment of obligations under the regulations.

If any of the persons representing or having interest in the acquirer is already a director on the board of the target company, and if such person(s) is an "insider" within the meaning of SEBI (Insider Trading) Regulations, 1992, he should rescue himself and not participate in any matter(s) concerned or 'relating to the offer

including and preparatory steps leading to the offer". On or before the date of issue of public announcement of offer, the acquirer should create an escrow account.
The acquirer should ensure that firm financial arrangement has been made for fulfilling the obligations under the public offer and suitable disclosures in this regard should be made in the public announcement of offer.

The acquirer should, within a period of 30 days from the date of the closure of the offer, complete all procedures relating to the offer including payment of consideration to the shareholders who have accepted the offer and for the purpose open a special account. In case of failure due to non-receipt of requisite statutory approvals the SEBI, on being satisfied that it was not due to any willful default/neglect of duty/ failure to diligently pursue the application for such approval, grant extension of time. The acquirer would have to pay interest for delay beyond 30 days as specified by SEBI from time to time. \If the failure to obtain, the requisite statutory approvals in time is on account of willful default or neglect/action or non-action on his part, the amount in the escrow account would be forfeited, while the acquirer would be liable for penalty.

In the event of withdrawal of offer in terms of the regulations or in the event of non-fulfillment of obligations under the regulations, the acquirer should not make any offer for acquisition of shares of the target company for a period of six months from the date of public announcement of withdrawal and 12 months from the date of closure of offer..
If the acquirer, in pursuance to an agreement, acquires shares which along with his existing holding', if any, increases his shareholding beyond 15 per cent, such agreement for sale of shares should contain a clause to the effect that in case of non-compliance of any provisions of this regulation, the agreement for such sale should not be acted upon by the seller or the acquirer.

Where the acquirer or persons acting in concert with him has acquired any shares in the open market or through negotiation or otherwise after the date of public announcement, he should disclose the number, percentage, the price and the mode of acquisition of sub shares to the stock exchanges on which the shares of the target company are listed and to the merchant banker within 24 hours of such acquisition.
Where an acquirer has gained control over the target company, he would be debarred from disposing off/ otherwise encumbering its assets for a period of two years from the date of closure of public offer, if the public announcement and/or the letter of offer did not disclose his intention to do so except in the ordinary course of business.
General Obligations of the Board of Directors of Target Company Unless the approval of the general body of shareholders is obtained after the date of the public announcement of offer, the board of directors of the target company should not, during the offer period,:

(a) sell, transfer, encumber or otherwise dispose of, or enter into, an agreement for sale, transfer, encumbrance or for disposal of assets otherwise, not being sale or disposal of assets in the ordinary course of business, of the company or its subsidiaries. The right of the company to issue and allot shares carrying voting rights upon conversion of debentures already issued or upon exercise of

option against warrants as per predetermined terms of conversion! exercise of option would not be affected; or;

(b) issue any authorised but un-issued securities carrying voting rights during the offer period; and

(c) enter into any material contracts.

The target company should furnish to the acquirer, within 7 days of the request of the acquirer or within 7 days from the specified date, whichever is later, a list of shareholders or warrant holders or convertible debenture-holders, containing names, addresses, shareholding and folio number, and of those persons whose applications for registration of transfer of shares are pending with the company.

Once the public announcement has been made, the board of directors of the target company should not

(a) appoint as additional director in any casual vacancy any person(s) representing or having interest in the acquirer, till the date of certification by the merchant banker. However, upon closure of the offer and the deposit of the payable consideration in the special account, representation to the acquirer on the board/ control over the company can be given;

(b) allow any person(s) representing/having interest in the acquirer, if he is already on the board of the target company before the date of the public announcement, to participate in any matter relating to the offer including preparatory steps.

The board of directors of the target company may, if they so desire, send their unbiased comments and recommendations on the offer(s)/bid(s) to the shareholders, keeping in mind their fiduciary responsibility to them. For this purpose, they can seek the opinion of independent merchant bankers/committee of independent directors. They would be liable for misstatement or concealment of material information in the discharge of this function. They should facilitate the acquirer in verification of securities tendered for acceptances.

Upon fulfillment of all obligations by the acquirer as certified by the merchant bankers, the board of directors of the target company which transfer the acquired securities, whether under the agreement or from open market purchases in the name of the acquirer and/or allow such changes in the board of directors as would give representation on the board/control over the company.

General Obligations of the Merchant Banker Before the public announcement of offer is made, the merchant banker should ensure that (a) the acquirer is able to implement the offer; (b) the provision relating to escrow account has been made; (c) firm arrangement for funds and money for payment through verifiable means to fulfill the obligations under the offer are in place; and (d) the public announcement of offer is made in terms of the code/regulations.

He should furnish to the SEBI a due diligence certificate which should accompany draft letter of offer. He must ensure (i) that the draft public announcement and the letter of offer is filed with the SEBI, target company and also sent to all the stock exchanges on which the shares of the target company are listed, (ii) the contents of the public announcement of offer as well as the letter of offer are true, fair and adequate and based on reliable sources, quoting the source wherever necessary; and (iii)

compliance of all the regulations and any other laws or rules as may be applicable in this regard.

Upon fulfillment of all obligations by the acquirer, the merchant banker would cause the bank with whom the escrow amount has been deposited to release the balance amount to the acquirers. He should send a final report to the SEBI in within 45 days from the date of closure of the offer.

Competitive Bid Any person (other than the acquirer who had made first public announcement) who is desirous of making any offer, should, within a period of 21 days of the public announcement of the first offer, make a public announcement of his offer for acquisition of some or all of the shares of the same target company. Such an offer is deemed to be a competitive bid. Any competitive bid/offer should be for such number of shares which taken together with shares already held by him/person(s) acting in concert with him would at least equal the number of shares for which the first public announcement has been made. No public announcement for an offer or competitive bid can be made during the offer period except after the 21-day period from the public announcement of the first offer. Upon the public announcement of a competitive bides), the acquirer(s) who had made the public announcement(s) of the earlier offer(s), would have the option to make an announcement: (a) revising the offer; or (b) withdrawing the offer, with the approval of SEB!. However, if no such announcement is made within 14 days of the announcement of the competitive bides), the earlier offer(s) on the original terms would continue to be valid and binding on the acquirer(s) who had made the offer(s) except that the date of closing of the offer would stand extended to the date of closure of the public offer under the last subsisting competitive bid.

The acquirers who have made the public announcement of offer(s) including the public announcement of competitive bides) but have not withdrawn the offer would have the option to make upward revision in his offer(s), in respect to the price and then umber of shares to be acquired, at any time up to 7 working days prior to the date of closure of the offer. However, the acquirer would not have the option to change any other terms and conditions of their offer. Moreover, any such upward revision can be made only upon the acquirer

(a) making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made;
(b) simultaneously with the issue of public announcement informing SEBI, all the stock exchanges on which the shares of the company are listed, and the target company at its registered office; and
(c) increasing the value of escrow account.

Where there is a competitive bid, the date of closure of the original bid as also that of all the subsequent competitive bids should be the date of closure of public offer under the last subsisting competitive bid and the public offer under all the subsisting bids would close on the same date.

Upward Revision of Offer Irrespective of whether or not there is a competitive bid, the acquirer who has made the public announcement of offer, may make upward revision in his offer in respect to the price and the number of shares to be acquired, at anytime up to 7 working days prior to the date of the closure of the offer. But any

such upward revision of offer can be made only upon the acquirer. (a) making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made; (b) simultaneously with the issue of such public announcement, informing SEBI, all the stock exchanges on which the shares of the company are listed, and the target company at its registered office; and (c) increasing the value of the escrow account.

Withdrawal of Offer A public offer, once made, can be withdrawn only under the following circumstances, namely:

(a) the withdrawal is consequent upon any competitive bid;
(b) the statutory approval(s) required have been refused;
(c) the sole acquirer, being a natural person, has died; and
(d) such circumstances as in the opinion of SEBI merits withdrawal.

In the event of withdrawal of the offer, the acquirer or the merchant banker has to (a) make a public announcement in the same newspapers in which the public announcement of offer was published, indicating reasons for withdrawal of the offer; (b) simultaneously with the issue of such public announcement, inform (i) the SEBI; (ii) all the stock exchanges on which the shares of the company are listed: and (iii) the target company at its registered office. .

Provision of Escrow The acquirer should as and by way of security of performance of his obligations deposit at lest 25 per cent of the total consideration payable in the public offer up to and including Rs 100 crore and 10 per cent of the consideration in excess of Rs 100 crore in an escrow account. For offers which are subject to a minimum level of acceptance and the acquirer does not want to acquire a minimum of 20 per cent, 50 per cent of the consideration payable under the public offer in cash should be deposited in the escrow account. The total consideration should be calculated assuming full acceptances and at the highest price if the offer is subject to differential pricing irrespective of whether the consideration for the offer is payable in cash or otherwise. To ensure that the escrow account does not become too onerous burden on the acquirer, it should consist of (a) cash deposit with a scheduled commercial bank; or (b) bank guarantee in favour of the merchant banker; or (c) deposit of acceptable securities with appropriate margin, with the merchant banker.

Where the escrow account consist of deposit with a scheduled commercial bank, the acquirer should, while opening the account, empower the merchant banker appointed for the offer to instruct the bank to issue a banker's cheque or demand draft for the account lying to the credit of the account. In case the escrow account consists of bank guarantee, it should be in favour of the merchant banker and would be valid for a period from the date of public announcement till after 30 days from the date of closure of the offer. The acquirer should, in case the escrow account consists of securities, empower the merchant banker to realise the value by sale or otherwise and if there is any deficit on realisation, he should be able to make good such deficit. The approved securities or bank guarantee included in the escrow account deposited with the merchant banker, cannot be released by the merchant banker till/ after completion of all obligations.

The value of the' escrow account should be increased to equal at least 10 per cent of the consideration payable upon upward revision of offer consequent upon a competitive bid or otherwise. Where the escrow account consists of bank guarantee or deposit of approved securities, the acquirer should also deposit with the bank a sum of at least 1 per cent of the total consideration payable, as and by way of security for fulfillment of the obligations by the acquirers. In case of non-fulfillment of obligations by the acquirer, t SEBI is empowered to forfeit the escrow account either in full or in part. The account deposited with t bank in cash would be released only (a) the entire amount to the acquirer upon withdrawal of offer certified by the merchant banker; (b) for transfer to the special account provided the amount so release does not exceed 90 per cent of the cash deposit in the escrow account (25 per cent of consideration pay at up to Rs 100 crore and 10 per cent of the excess amount); (c) to the acquirer, the balance of 10 per cent cash deposit on completion of all obligations and upon certification by the merchant banker; (d) the ent amount to the acquirer upon completion of all obligations and upon certification by the merchant bank where the offer is for exchange of shares/other secured instruments; (e) the entire amount to the merchant banker, in the event of forfeiture for non-fulfillment of any of the obligations, for distribution after deduction of expenses, if any, of the merchant banker and registrar to the offer in the following manner:

- One-third to the target company;
- One-third to the regional stock exchange for credit to the investor protection fund/any other similar fund for investor education, research, grievance redressal and similar such purposes specified SEBI from time to time; and
- Residual one-third to be distributed pro-rata among the shareholders who have accepted the offer.

In the event of non-fulfillment of obligations by the acquirer, the merchant banker must ensure realisation of escrow account by way of foreclosure of deposit, invocation of bank guarantee or sale of securities a credit the proceeds to the regional stock exchange of the target company for the credit of the investor protection fund or any other similar fund.

Payment of Consideration For the amount of consideration payable in cash, the acquirer must, with a period of 21 days from the date of closure of the offer, open a special account with a banker(s) to an is! registered with SEBI and deposit such sum as would, together with 90 per cent of the amount lying in 1 escrow account, if any, make up the entire sum due and payable to the shareholders as consideration acceptances received and accepted and, for this purpose, transfer the funds from the escrow account. 1 unclaimed balance lying to the credit of the special account at the end of 3 years from the date of deposit should be transferred to the investor protection fund of the regional stock exchange of the target company. In respect of consideration payable by way of exchange of securities, the acquirer must ensure that securities are actually issued and dispatched to the shareholders.

Bail-out Takeovers Such takeovers refer to a substantial acquisition of shares in financially we company, not being a sick industrial company, in pursuance to a scheme of rehabilitation approved by public financial institution or a scheduled bank (lead institution). The lead institutions would be responsible for ensuring compliance with the code. They would appraise the financially weak company taking on account the financial viability, and assess the requirement of funds for revival and draw up the

rehabilitate package on the principle of protection of interests of minority shareholders, good management, effect revival and transparency. The rehabilitation scheme has also to specifically provide the details of change in management. It may provide for acquisition of shares in the financially weak company in any the following manner:

(a) outright purchase of shares,
(b) exchange of shares,
(c) a combination of the scheme as far as possible may ensure that after the proposed acquisition the erstwhile promoters do I own any shares in case such acquisition is made by the new promoters pursuant to such scheme. 'financially weak company' means a company, which has at the end of the previous financial year accounted losses, which has resulted in erosion of more than 50 per cent but less than 100 per cent of its worth (the sum total of the paid-up capital and free reserves) as at the beginning of the previous finance year.

Manner of Acquisition of Shares Before giving effect to any scheme of rehabilitation, the lead institution should invite offers for acquisition of shares from at least three parties. After receipt of the offers, they should select one of the parties having regard to the managerial competence, adequacy of financial resources and technical capability of the person acquiring shares to rehabilitate the financially weak company. The lead institution would provide necessary information to any person intending to make an offer to acquire shares about the financially weak company and particularly in relation to its present management, technology, range of products manufactured, shareholding pattern, financial holding and performance and assets and liabilities of such company for a period covering five years from the date of the offer as also the minimum financial and other commitments expected of from the person acquiring shares of such rehabilitation.

Manner of Evaluation of Bids The lead institution should evaluate the bids received with respect to the purchase price or exchange of shares, track record, financial resources, reputation of the management of the person acquiring shares and ensure fairness and transparency in the process. Based on the evaluation, the offer received should be listed in order of preference and after consultation with the persons in the affairs of the management of the financially weak company accept one of the bids.

Person Acquiring Shares to Make an Offer The person acquiring shares who has been identified by the lead institution should, on receipt of a communication in this behalf from the lead institution, make a formal offer to acquire shares from the promoters or persons in charge of the affairs of the management of the financially weak company, financial institutions and also other shareholders of the company at a price determined by mutual negotiation between the person acquiring the shares and the lead institution. The lead institution can offer the shareholdings held by it in the financially weak company as part of the scheme of rehabilitation.

Person Acquiring Shares to Make Public Announcement The person acquiring shares from the promoters or the persons in charge of the management of the affairs of the financially weak company or the financial institution must make a public announcement of his intention for acquisition of shares from the other shareholders of the company containing relevant details about the offer including the information about the identity and background of the person acquiring shares, number and percentage of shares proposed to be acquired, offer price, the specified date, the date

of opening of the offer and the period for which the offer would be kept open and such other particulars as may be required by the SEBI. The letter of offer has to be forwarded to each of the shareholders other than the promoters or the persons in charge of management of the financially weak company and the financial institutions.

If the offer results in the public shareholding being reduced to 10 per cent or less of the voting capital of the company, the acquirer should

(i) either, within a period of three months from the date of closure of the public offer, make an offer to buyout the outstanding shares remaining with the shareholders at the same offer price, which may have the effect of deli sting the target company or

(ii) undertake to disinvest through an offer for sale or by a fresh issue of capital to the public which would open within a period of six months from the date of closure of public offer, such number of shares as would bring the public shareholding to a minimum of 25 per cent or more of the voting capital of the target company so as to satisfy the listing requirements. For the purpose of computing the required percentage, the voting rights as at the expiration of 30 days after the closure of the public offer should be reckoned. The letter of offer should state clearly the option available to the acquirer.

While accepting the offer from the shareholders other than the promoters or persons in charge of the financially weak company or the financial institutions, the person acquiring shares must offer to acquire from the individual shareholder his entire holdings if such holding is up to 100 shares of face value of Rs 10 each or 10 shares of the face value of Rs 100 each.

Competitive Bid : A person is not allowed to make a competitive bit for acquisition of shares of the financially weak company, once the lead institution has evaluated and accepted the bit of the acquirer who has made the public announcement of offer for acquisition of shares from the shareholders other than the promoters or the persons in charge of the management of the financially weak company.

Exemption Offers made in pursuance of ball-out takeovers can be exempted by SEBI from the provisions of substantial acquisition of shares. But the lead institution or the acquirer, as far as may be possible, should adhere to the time limits specified for various activities for public offer specified for substantial acquisition of shares.

Acquisition of Shares by State Level Public Financial Institutions Where proposals for acquisition of shares in respect of a financially weak company is made by a state-level public financial institution, the above provisions in so far as they relate to scheme of rehabilitation prepared by a public financial institution, would apply except that in such a case the Industrial Development Bank of India, should be the agency for ensuring the compliance of these regulations for acquisition of shares in the financially weak company.

INVESTIGATION AND ACTION BY SEBI

The SEBI may appoint one or more persons as investigating officer to undertake investigation for any of the following purposes: (a) to investigate into the complaints received from the investors, the intermediaries or any other person on any matter having a bearing on the allegations of substantial acquisition of shares and takeovers; (b) to investigate *suo-moto* upon its own knowledge or information, in the interest of

securities market or investors interests, for any breach of the regulations; (c) to ascertain whether the provisions of the SEBI Act and the regulations are being complied with.

Before ordering such an investigation, it has to give not less than 10 days notice to the acquirer, the seller, the target company, the merchant banker, as the case may be. However, if it is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing, direct that such investigation be taken up without such notice. During the course of an investigation, the acquirer, the seller, the target company, the merchant banker, against whom the investigation is being carried out would be bound to discharge his obligation as detailed below.

Obligations It would be the duty of the acquirer, the seller, the target company, the merchant banker whose affairs are being investigated and of every director, officer and employee to produce to the investigating officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities as the investigating officer may require, within such reasonable period as he may specify. They should allow him to have reasonable access to the premises occupied by him or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in their possession and also provide copies of documents or other materials, which in his opinion, are relevant for the purpose of the investigation. In the course of investigation he would be entitled to examine or to record the statements of any of their directors, officer or employees who must give to the investigating officer all assistance in connection with the investigation, which he may reasonably require.

The investigating officer would submit a report to SEB!. If directed to do so, he may submit interim reports also. After consideration of the investigation report, SEBI would communicate the findings of the investigating officer to the acquirer, the seller, the target company, the merchant banker, as the case may be, and give him an opportunity of being heard. On receipt of the reply, if any, it may call upon them to take such measures as it may deem fit in the interest of the securities market and for due compliance with the provisions of the SEBI Act and the regulations.

The SEBI may appoint a qualified auditor to investigate into the books of account or the affairs of the persons with the same powers of the investigating authority and the obligations of person concerned in would be applicable.
Directions by SEBI In the interest of the securities market, in addition to its right to initiate action including criminal prosecution, SEBI can give such directions as it deems fit including (a) directing the person concerned not to further deal in securities; (b) prohibiting the person concerned from disposing of any of the securities acquired in violation of these regulations; (c) directing the person concerned to sell the shares acquired; (d) taking action against the person concerned who is an intermediary holding a certificate of registration.
Penalties for Non-Compliance Any person failing to make disclosures as required would be liable to action in terms of the regulations and the SEBI Act. The failure to carry out the obligations under the regulations by the acquirer or any person(s) acting

in concert with him would lead to forfeiture of part or entire sum deposited with the bank in the escrow account and also action in terms of the regulations and the SEBI Act. The board of directors of the target company failing to carry out their obligations would be liable for penal action. .

The SEBI may for failure to carry out the requirements of the regulations by an intermediary, initiate action for suspension or cancellation of his registration according to the procedure specified in the regulations applicable to such intermediary.
For any misstatement/concealment of material information required to be disclosed to the shareholders/ directors where the acquirer is a body corporate/directors of the target company, the merchant banker to the public offer and the merchant banker engaged by the target company for independent advice would be liable for penal action. The penalties may include (a) criminal prosecution, (b) monetary penalties, (c) directions under the SEBI Act. Any person being aggrieved by an order of SEBI may prefer an appeal to the central government.

HOSTILE TAKEOVER

Strategies The acquirer company can use any of the following techniques aimed at taking over the target company.
Tender Offer This involves an open offer to all shareholders to buy their stakes. It should be made after the bidder has already picked up an equity stake.
Street Sweep This technique requires that the acquirer should accumulate large amounts of stock in a company before making an open offer. The advantage is that the target firm is left with no choice but to give in.
Bear Hug In this case, the acquirer puts pressure on the management of the target company by threatening to make an open offer. The board capitulates straight-away and agrees for settlement with the acquirer for change of control.
Strategic Alliance This strategy involves disarming the opposition by offering a partnership rather than a buyout. The acquirer should assert control from within and take over target company.

Brand Power is to enter into alliance with powerful brands to displace the partner's brands and as a result, buy out the weakened company.
Defensive Strategies The target company can also use one of the following strategies to defend itself against the attack mounted by the acquiring company in its bid for open-market takeover.

Poison Pill This strategy involves issue of low price preferential shares to existing shareholders to enlarge the capital base. This would make hostile takeover too expensive. Poison Put In this case, the target company can issue bonds that encourage holders to cash in at high prices. The resultant cash-drainage would make the target unattractive. Greenmail Under this strategy, the target company should repurchase the shares cornered by the raider. The profits made by the raider are after all, akin to blackmail and this would keep the raider at a distance from the target.
Pac-man Defense This strategy aims at the target company making a counter-bid for the raider's company. This would force the raider to defend himself and the predator must call off his raid.

White Knight In order to repel the moves of the raider, the target company can make an appeal to a friendly company to buy all, or part of the company. The understanding is that the friendly buyer promises not to dislodge management of the target company.
White Squire This strategy is essentially the same as 'White Knight' and involves sell out of shares to a company which is not interested in the takeover. As a consequence, the management of the target company retains its control over the company.

MERGERS AND ACQUISITIONS BANKER

The Basics

If marriages are made in heaven, you need a lot of important people who would facilitate them. Our interest in any marriage would be limited to the fun and frolic associated with it. Believe me, corporate marriages are not fun. The mega-buck, mega-sized “deals” make or break the company, enrich or pauperize investors, and ultimately may or may not change the way business was done. Welcome to the world of Mergers & Acquisitions (M&A) where fame and fortune come easily to you, if you do have the skills to be an M&A banker.

Companies look at various ways to grow. One way to do so is Organic Growth, where the company ploughs back the profit it earns. This is done by distributing only a part of its earnings in the form of dividends, retaining a major portion and adding it to the capital of the business. The retained earnings (the accounting gurus among you can also read it as Reserves and Surplus), together with additional loans raised from the lenders, contribute to the expansion and growth of the company.

Organically, growth may take years to take place. In the dynamic corporate world, where few minutes’ delays could mean loss of millions, a few people would have the time to wait. It is then that the companies look at M&A as an alternative. Merger refers to finding an acceptable partner, determining upon how to pay each other and ultimately creating a new company, which is a combination of both the companies. Acquisition refers to buying out another company and taking it into the fold of the acquiring company. This is done by paying the acquired company, the value of its capital and depending upon the circumstances, a premium over the capital amount. Since the differences are only technical, we refer to all such business restructuring measures as M&A activities. The other related terms are buyouts, purchases, takeovers etc.

The organization and the job

The consultation experts for M&A are normally referred to as M&A bankers or executives. They work in the M&A department of Investment Banks, the financial services organization that chiefly cater to such demands of their corporate clients. Investment banks offer wide range of services to its clients. The services can be in different forms:
The investment bank approaches a prospective client with the suggestion to take over a company and expand its operations.

The client comes to the investment bank and asks whether it should go for an M&A, in the first place.

The client recognizes the need to go in for M&A, but is not able to find a suitable partner. So the investment bank searches for a suitable partner, based on the profile of the client as well as its ideas and ambitions regarding growth.
Either the investment bank or the client by itself would identify a company (say, X) for acquisition or merger. The M&A team would now go to the management of X representing the client, to convince X to sell out or merge with the client. The banker would also negotiate on behalf of the client to determine the price to be paid, the mode of payment and other terms of the deal. (If X doesn't want to sell out, there might also be a case of hostile takeover bid).

The process can happen on the reverse side when the client approaches the investment bank for selling out to a bigger company.

The person

People involved in an M&A deal end up with tons of deal fees and bonuses. They also frequently find their name in the newspapers, particularly if the merging companies are big enough. To become a successful M&A banker you should have qualities like communication skills, a pleasing personality, a head for relationships, the knowledge of law of the land (especially the legislations pertaining to takeovers, share transfers and buybacks) and sound analytical skills.

As a banker you might have to do tough negotiations in order to bring about the deal. This requires good oral communication abilities and a clear thinking. In the process of negotiations, numerous offers and counter-offers would be made. Deep analytical skills and quick thinking are needed to immediately understand the implications of all such terms. Strong mental abilities and personality is necessary for quick decision-making. The work also entails good deal of diplomacy and patience so that the deal doesn't fail due to the impertinence of the intermediary.

One should also be a good team worker. Apart from the members of your own organization, you also need to work with the executives/management of the client. While working out the details of the deal, one also has the other company's officials on the team. Moreover, the banker has to work with similar bankers of other investment banks who might be representing both the companies. Here too, team skills and inter-personal skills are called to the fore.

Sound financial skills are required as many aspects of the merger are numerical in nature. You might even have to identify the synergies involved in the merger (the theory of synergy says 2 + 2 = 5, not just four). Legal knowledge, documentation skills and taxation knowledge are highly welcome. For originating deals, strategic thinking and creativity in identifying business synergies are essential. Additionally, all other abilities like working for long hours, flying from an airport to another (sometimes internationally), sustaining on pathetic desktop lunches etc., would also be helpful.

The background and the payoff

As young aspirants, you have the best bet through campus interviews. Normally, MBAs of premier institutes are high in demand, solicited by the reputed investment banks. Professional qualifications like CFA from ICFAI and CA from ICAI, a degree

in law, economics or so would add high value. One can also specialize in an industry by thorough research and knowledge of contemporary business trends.

The starting salaries could reach mind-boggling levels based on the institute and the campus recruiter. They could be anywhere between two lakhs to several lakhs per annum. Then there are the annual performance bonuses based on the deal values and the successful execution. Above all, if you have an inclination for popularity, look no further.

20 Jun 2003

The win-win deal

The L&T-cement deal makes Grasim the largest player in the country--and a win-win one for both the companies. - Puneet Wadhwa

Grasim Industries has finally managed to bag L&T's cement division (capacity of 16.5 million tonnes). With a total capacity of about 31 million tonnes, Grasim is now the largest cement manufacturer in the country and the seventh largest in the world. L&T's cement business was valued at Rs 6000 crore (Rs 363 per million tonne), and will be de-merged into a separate Cement Company (CemCo). In the new entity, L&T would retain 20 per cent equity and the balance would be distributed to other shareholders in CemCo, in proportion to their shareholding in L&T.

In November 2001, Grasim had acquired 10.72 per cent stake in L&T from Reliance Industries which invited a probe by the the stock market regulator Securities Exchange Board of India (SEBI), under the takeover code. Grasim will, however, offload its entire stake in L&T at Rs 120 per share in favour of L&T foundation, created by L&T's employees. Speculation of foreign players like Lafarge entering the Indian markets through L&T is finally over with Grasim pulling off the deal.

According to the deal, Grasim would first acquire 8.50 per cent share of CemCo from L&T at Rs 171.30 per share, followed by an open offer—at the same price—to the shareholders of CemCo for acquiring another 30 per cent of the equity to gain management control (See sideshow: The Takeover Route).

Who gains what?

ACC-GACL combine virtually control the northern markets, besides having a strong presence in eastern India; Grasim has a strong presence in Karnataka and L&T in Gujarat and Maharashtra. This deal would result in gains for Grasim on many fronts. "Once the units are integrated, Grasim will be able to save on the costs through freight rationalisation that would improve the bottomline. Moreover, it will also command the pricing in the regions where it has a strong presence," says Kaushal Shah, analyst, LKP Shares and Securities Limited.

Advantage L&T shareholders?

Says an industry analyst, "For L&T, this deal will reduce its debt burden by Rs 1863 crore, resulting into interest-cost savings of Rs 150 crore per annum. This will create long-term value for L&T, with a possible re-rating for being a focused engineering player."

Recent reports of the cement cartel being active again may lead to a curtailment of supply and an increase in prices over the next few months. Prices have reportedly firmed up by Rs 10 per bag (Rs 150 earlier) in southern India and a similar trend is expected in the northern region, too. And the demand for cement is likely to pick up as a result of many ongoing huge infrastructure projects. However, Grasim will have to gradually reduce the debt burden of CemCo before it can reap the benefits of this acquisition.

Staid Tata group dons racier mantle

Business Standard - Mar 20, 2002

The bronze bust of Jamshedji Tata looks on impassively as visitors pass the portals of Bombay House, the stately headquarters of the Indian conglomerate he founded 134 years ago. The company has come a long way from its textile and trading roots, but even emerging in the 21st century struggled to shake off a reputation for being stolid and slow compared with the country's more nimble companies. That is, until last month.

On February 5, the Tatas handed the relatively sprightly refining-to-telecoms group Reliance an embarrassing defeat by winning the bid for Videsh Sanchar Nigam Ltd, a state-run overseas telephone firm sold off by the government. The purchase was the latest sign of dramatic changes at the group in the past few years, involving rebranding of its name, snazzy marketing, innovative products and its most aggressive mergers and acquisitions campaign.

"The VSNL acquisition is a clear sign the Tatas have become more aggressive, willing to pay premium prices and get things moving with the government," says Gita Piramal, author of Business Maharajas, an acclaimed book on industrial families. "All through the seventies, eighties and nineties, the Tatas were never able to get anything done. But now at least they are not being penalised for being too honest," she says.

The group has long enjoyed a clean image avoiding some of the hard government lobbying many other companies adopted. Charitable trusts own 66 per cent of Tata Sons, the holding company of the group. Tata, with an $8.5 billion turnover, was dethroned as the country's top private group by sales last year when the Reliance conglomerate topped with $12.36 billion after its 540,000-barrels-a-day refinery (Reliance Petroleum) went on stream.

Mindful of change

The Tata group, which has 94 companies and 225,000 employees, seems bemused over the hoopla surroundings its purchase of VSNL but acknowledges it is in the middle of a period of change and most market watchers are up-beat about the new-look Tata. "They're going in the right direction," said Jaideep Goswami, head of equities at ITU Securities. "They still need to work on their speed of response to situations, but have largely got their act together over the last two years."

Last month Tata signed up racing car driver Narain Karthikeyan, 26, a member of the Formula One teams of Jaguar and Jordan, to endorse its products. "He's ambitious and has a global vision," says R Gopalakrishnan, executive director of Tata Sons. "That fits in with what Tata wants to do in telecoms, software and cars all sexy new areas." The suave Gopalakrishnan, 57, was recruited from Unilever's Indian operations in 1998 and is thought to be the man behind many changes in the group.

"We want to be part of the future," he says. "A multi-product group can mirror approximately the national economy. But we went into software and telecoms long before it became fashionable. Now we're taking strong initiatives in those high growth areas." Gopalakrishnan says half of Tata's turnover will come from branded products and services by 2007, against 20 per cent in the early 1990s.

"We believe that over 15 years, well have completely reorganised the portfolio of products in terms of sales, profits and market capitalisation," he says. "Further

investments will largely be in the services sector," he says. The group has dominated smokestack industries, such as India's largest private sector steel maker Tata Iron and Steel Company, its largest private sector utility Tata Power Co and India's largest truck maker, Tata Engineering and Locomotive Co.

Single identity

In the last four years the group has centralised advertising, designed a common logo and made companies sign a code of conduct and pay fees for using the Tata name. "Clearly the Tatas have moved from being a confederation of companies to a single homogenous grouping," says Piramal. "And being a tighter ship means that there's now more emphasis on profitability," she adds.

The first indications of a new-look Tata came from Telco through the introduction of a hatchback, the country's first home-developed car called the Indica. "The Indica proved afresh to the group that they could take on difficult projects and succeed," says Sunidhi Consultancy auto analyst Richard D'Souza. "If s given them direction and steam."

On the prowl

The group has seen more mergers and acquisitions by value in the last three years than ever before, including the largest acquisition abroad by an Indian group when it bought British tea maker Tetley in 2000 to became the world's largest producer of packaged teas. Other ventures have included in telecoms, including a tie-up with American giant AT&T which led to the creation of India's biggest telecoms company with a million subscribers and further development of Tata Consultancy Services, India's biggest software exporter.

Tata Power is bidding for Enron's $2.9-billion Indian power plant, and another anticipated big event is the possibility of an initial public offering of TCS, possibly India's biggest "I expect a year of further growth through acquisitions," Piramal says.

MANAGING THE PEOPLE ISSUES OF MERGERS AND ACQUISITIONS

People issues are most sensitive issues in case of mergers and acquisitions negotiations but it has been found that these issues are often being overlooked. Prior to the signing of an agreement, both parties expend enormous energy scrutinizing financial variables, contemplating and engaging in the give-and-take of negotiations. Before the new organization is formed, goals are established, efficiencies projected, and opportunities appraised as staff, technology, products, service and know-how are combined under one roof. All these activities are planned prior to the public announcement of the deal and implemented immediately upon signing the final documents.

But what happens to the employees of the two companies? How will they adjust to the new corporate environment? Will some choose to leave? These are but a few of the many challenges employers face during a merger or acquisition. Generally most of the time is spent in setting modalities of mergers and acquisitions and then implementation is done as soon as the deal is signed. But more than likely, no one works out with the same sharp focus how the combined organization's top-level and middle managers will work as one unified team, especially when duplication of functional responsibilities exists between the two companies. This is why the transition period following an acquisition is usually a time of great organizational upheaval.*At least one corporate culture and many jobs are at stake*. As the merger moves forward the newly formed organization enters a difficult transition period. Now the people side of the equation comes into play, when the vision and possibilities of the new organization capture the imagination of employees or does not.

Management must quickly determine, foster and inculcate the values, philosophy and style it wishes to represent. In a very brief span, management has to establish the operating environment and determine how its employees, clients and the public will perceive the new organization.*Its on the perception of the workers that a large amount of success of these mergers and acquisitions depend.* Employees at these juncture often find themselves in dilemma and have apprehensions regarding the change. It is at this juncture that a sense of direction to be given to them by the new leaders, their doubts and apprehensions to be cleared as soon as possible. Most importantly there should be a clear and unambiguous communication between the new management and employees. It must be kept in mind that whatever happens during the transition period is very hard to undo. *First impressions become long lasting*. It is a time of major upheaval: Management is trying enthusiastically to implement changes while employees are feeling extremely tenuous about their job security and personal career plans. It is virtually impossible to do an in-depth human resources audit before the deal is struck. So, management must move quickly to identify the internal leaders and key contributors who can fill crucial roles in the new organization not an easy task.
The challenge is to create an environment where people want to compete for a role, without making promises or causing defections.

The process of selecting the final management team focuses on assessing each senior manager's strengths and weaknesses. Emphasis should be placed on their potential to cooperate productively with their counterparts from the other company, as well as on

technical and functional skills. Their ability to provide a strategic viewpoint on managing the merged operations also is crucial. Additionally, they need to be quick learners and genuinely excited by the opportunity to create a new organization. The principal goals of the transitional management team are to manage organizational stress, establish performance criteria, identify who will stay and who will go, create a new organizational structure, and assume the leadership of the emerging organization. Addressing employees' fears and concerns presents a tough challenge to many managers one that balances optimism and encouragement with the reality that some changes will need to be made. The best thing that can done for everyone involved is to let them know and understand that this a trying time, then clearly convey the goals of the new venture and how to approach these goals. We have to get people focused on solving external problems.

There are bound to be fears and conflicts throughout this volatile period. Ultimately, what will be remembered long afterward is the tone and the manner in which these situations were resolved. Nearly everyone understands early on who is in charge; the challenge is to win employees' cooperation and trust so that an accurate assessment of their capabilities can be made.

In cases of job overlap, it is assumed that the acquiring or dominant company's employees will fill the positions. This makes for a number of pre-planned, day one casualties. But if handled in a straightforward, sensitive manner, the outcome will be viewed by those who have to leave as well as those who stay as an unfortunate though necessary part of the merger. These changes, which usually can be determined during the pre-merger activities, need to be made as quickly as possible. Other changes are not that clear cut in approach and thus require a deeper understanding in the context of the transitional environment. As part of this assessment process, individual performance standards need to be established to reflect the goals of this new organization. These standards, if communicated effectively and monitored regularly, can convey the organization's desire to work cooperatively with employees through the difficult transition period. It is through this system that the new organization's emerging culture starts to become the shared experience of those who work within it.

As the transition begins to unfold, people will generally fall into three categories: those who resist change and can't or won't adapt; those who resist change but have the capacity to modify their point of view; and those who welcome the change. If the transitional goals are clearly communicated, those who sign-on first will be the third group.

Those who resist change but are able to modify their point of view are the next group to focus on. They require some time and persuasion to get used to an idea and to participate. Those who can't buy in will be unable to contribute to the new culture and may have to be let go.

For those individuals who don't want to change, or don't have the technical ability to contribute to the emerging organization's new direction, cuts should be made quickly but with sensitivity and generosity. Outplacement is a valuable resource to aid in this process

As the transition begins, the two cultures should combine to create a unique culture. At the onset of the transitional phase, the new owners have an idea of what they want to do, but there is already a culture in place in fact, several cultures.

Management has to define a transitional vision, and sell it within the organization, along with the promise that the final culture, goals and vision will be formed as a product of the transition. This may sound difficult because many people will be hanging on to their old ways. But the truth is that most employees will expect and accept change, as long as they have an opportunity to participate in its evolution.

Many will even welcome it. During this brief transition time, everyone involved must learn an entirely new way of relating between the different cultures. The synergies, if managed correctly, could lead to an organization with greater employee participation, flexibility and risk-taking and, where necessary, a higher degree of structure.
Once the leadership has set a course, tensions have been reduced, steps taken to establish a unifying culture, and a determination made concerning who will stay and who will go, the venture is ready to leave the transition stage and emerge as a new organization. At this point, management can begin to focus on the business of running the business. In the best cases, the new organization proceeds with a fresh outlook and attitude, infused with energy. Substantial opportunities are created from the combined markets, economies of scale are created from downsizing, and, ultimately, the bottom line improves.
In the long run, successful mergers and acquisitions occur when:

- Both sides are open to new possibilities.
- With cooperation, flexibility and accurate information, the planning and assessment process has the best opportunity to progress smoothly.
- Open channels of communication, which help, minimize confusions and build confidence in employees.
- Top management is receptive holds a clear-cut vision, knows how to generate consensus and convince people about organizational goals.

However, if the transition phase is not managed with openness and clear signals, cultures will clash, employees will scurry and jockey for power, the rumor mill will create confusion, the best people will pack their bags, crisis management will take over, and the downward spiral will begin.
Hence it becomes very important to tread on carefully during first few months of a merger or acquisition. It is at this juncture that a corporate leader has to face most demanding challenge.

LESSON 37
STOCK BROKING: AN INTRODUCTION AND SEBI GUIDELINES

Lesson Objectives: To understand the stock broking activity,
SEBI regulations related to stock broking activity.

INTRODUCTION

In India, stock exchanges were almost self regulatory till 1988, supervised by Ministry of Finance under the Securities Contracts Regulation Act (SCRA). However, the stock exchanges were not discharging their self-regulatory role as well as a result of which malpractices crept into trading, adversely affecting investor's interests. SEBI has been setup to ensure that the stock exchanges discharge their self-regulatory role properly. Ever since SEBI began to monitor brokers, stock broking is emerging as a professional advisory service, in tune with the requirements of a mature, sophisticated, screen based, ring-less, automated stock exchanges in the country in sharp contrast to traditional, closed character as inherited family business.

So we will discuss, the Indian Stock Broking system here. The stock broking activity consists of various intermediaries. Let us discuss them one by one.

STOCK BROKERS

Stockbroker is a member of a recognized stock exchange who buys, sells or deals in securities. To work as a stockbroker registration with SEBI is mandatory. SEBI is empowered to impose conditions while granting the certificate of registration.

Registration : A broker seeking registration with SEBI, has to apply through the stock exchange of which he is member. For registering SEBI checks - eligibility of the applicant to become the member of stock exchange, has the necessary infrastructure to effectively discharge his duties, past experience etc.

Every registered stockbroker is required to pay annual fee @ Rs. 5,000 for turn over up to Rs. 1 crore and 0.01% of turnover exceeding Rs. 1 crore. For calculating turnover underwriting and collection of deposits are not taken into account for the purpose of calculating the turnover. The authenticity of the annual turnover is to be certified by the stock exchange concerned.

Capital adequacy norms for brokers : An absolute minimum of Rs. 5 lakh as a deposit with the exchange is to be maintained by the members of the BSE & CSE and Rs. 3.5 lakh for DSE and ASE irrespective of volume of business. In case of other SE the minimum requirement is Rs. 2 lakhs. The security deposit kept by the members in the SE forms part of the base minimum capital; 25% of the base minimum capital is to be maintained in case with the exchange. Another 25% remains in the form of a long term fixed deposit with a bank on which the SE is given free lien. The remaining requirement is being maintained in the form of securities with a 30% margin. The securities should be in the name of the member and are pledged in favor of SE.

Additional capital related to Volume of Business : The additional or optional capital required from a member should, at any point of time, be such that together with the base minimum capital it is not less than 8% of the gross outstanding business in the

exchange defined as the aggregate of up-to-date sales and purchases by a member broker in all the securities put together.

Duty to the Investor : The duties of a broker to the investor are

(i) He should be faithful to the clients in his dealings with them and execute orders as per the instructions.
(ii) He should issue to his clients a contract note without any delay for all transactions in the form specified by the SE.
(iii) To avoid breach of trust, he should not disclose or discuss with any other person details of investment and transaction of clients.
(iv) He should not mislead clients merely to generate business.
(v) He should avoid dealing with a client who is a defaulter in his dealings with other brokers.
(vi) When dealing with a client, he is required to disclose whether he is acting as a principal or as an agent.
(vii) He should not give investment advice to any client unless sought by him.
(viii) A stockbroker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients.
(ix) He should extend full cooperation to other brokers in protecting the interest of his clients regarding their rights to dividends, bonus shares, rights issues and any other rights related to such securities.

SUB BROKERS

A sub-broker acts on behalf of a stockbroker as an agent or otherwise for assisting investors in buying, selling or dealing in securities through such brokers but he is not a member of a stock exchange. To act as a sub-broker, registration with SEBI is required. It grants a certificate of registration to a sub-broker subject to the conditions that (a) he has to pay the prescribed fee, (b) he takes adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keeps SEBI informed about the number, nature and other particulars of the complaints (c) he is authorized in writing by a broker for affiliation in buying, selling or dealing in securities.

Registration of Sub-brokers : According to SEBI regulations currently in force, a sub-broker is required to submit along with the application (a) recommendation from a stockbroker with whom he will be affiliated and (b) two references, including one from his banker. The individual applicant should not be less than 21 years of age, has not been convicted in any offence involving fraud or dishonesty and has passed the equivalent of at least 12^{th} standard from a recognized institution.

The annual fee payable by a sub-broker is Rs. 1000 for an initial period of five years. After the expiry of five years, an annual fee of Rs. 500 is payable as long as the certificate remains in force.

Duty to the investors : A sub-broker, in his dealings with the clients and the general investing public, should faithfully execute the orders for buying and selling of securities at the best available market price and promptly inform his clients about the execution of an order and make payment in respect of securities sold and arrange for prompt delivery of securities purchased.

He should issue promptly to his clients (a) purchase or sale notes for all the transactions entered into by him with his clients, or through the principal broker (b)

scrip-wise details. He should not furnish misleading information to his clients to generate business. He should not recommend his clients any scrip / security unless the client has asked for the advice.

FOREIGN BROKERS

Foreign institutional investors (FIIs) now play a significant role in the stock markets. With a view to helping the FIIs to follow the procedures and encourage them to invest in India, SEBI has issued a different set of guidelines:

Registration with SEBI : It is mandatory for a foreign broker to get registered with SEBI in order to do business in India. While applying for registration, a foreign broker has to disclose to SEBI name(s) and registration number(s) of the stock exchanges where he is registered in the capacity of a broker dealer together with an undertaking that he would operate and assist only on behalf of the registered FIIs and would not deal in securities on his own account as principal in India. On advice from SEBI, the RBI would accord approval to him to open (a) a foreign currency denominated bank account and a rupee account with a designated bank branch and (b) multiple custodian accounts with the approved custodian of all registered FIIs whom he may be assisting or on whose behalf he would be placing orders with a member of Indian stock exchanges.

Transaction in Accounts : The foreign currency denominated accounts of registered foreign brokers would be credited with inward remittance brought in by him and inward remittance to make initial payment against the purchase contracts on behalf of registered FIIs. The rupee account will be credited with the commissions / brokerages earned by him in India. Initial payment on account of purchase contract on behalf of registered FIIs would be made through Rupee account. Reimbursement of this initial payment would be made by the designated bank/custodian of the registered FII.

The brokers are allowed to freely repatriate commission/ brokerage earned in India after transferring them to the foreign currency denominated account subject to payment of taxes on the basis of conversion of rupees to foreign currency at the prevailing market rates.

After discussing the intermediaries in the stock market, now let us discuss the system of stock market trading in India.

STOCK MARKET TRADING

We will discuss the stock trading activity with reference to National Stock Exchange Ltd, in short NSE. Before setting up NSE, Indian stock exchanges were operating only in cities in which they were setup. The NSE represented an attempt to overcome the fragmentation of regional markets by providing screen-based system, which transcends geographical barriers. The main objective has been to set up comprehensive facilities for the entire range of securities under a single umbrella. We can describe the main objective as

1. To set up a nationwide trading facility for equities, debt instruments and hybrids.
2. To ensure equal access to investors across the country through an appropriate communication network.
3. To provide a fair, efficient and transparent securities market to investors using the electronic trading system.

4. To ensure shorter settlement cycle and book entry settlement system and
5. To meet the current international standards prevalent in the securities markets.

The NSE has two segments for trading in securities: Wholesale Debt Market (WDM) and Capital Market (CM) segments. Separate membership is required for the two segments.

Wholesale Debt Market (WDM) Segment : The WDM segment provides a facility for institutions/ body corporate (institutional investors) to enter into high value transactions in instruments such as government securities, T-bills, public sector undertaking bonds, units of mutual funds, certificates of deposits, commercial papers etc. Only trading members can transact in WDM segment.

Trading Members : Recognized members of NSE are called trading members. Only body corporate, bank subsidiaries and financial institutions can become Trading members. They must possess a minimum net worth of Rs. 2 crore. The annual fee is Rs. 30 Lakh and a TM cannot withdraw his membership before five years. The applicant must be engaged solely in securities business and not in any fund based activity. The minimum paid up capital should be Rs. 30 lakh. TM can either trade on their own or on behalf of their clients, including participants.

Participants : Are the organizations directly responsible for settlement of trade. They are large players in the markets and as such take direct settlement responsibility of their own trades executed through TMs. The participants have access to the NSE trading system to enable to see the breadth and dept of the market through enquiry screens. They are able to monitor all market movements.

Capital Market (CM) Segment : It covers trading in equities and retail trade in debt instruments like non-convertible debentures and hybrid instruments. Individuals, registered firms, corporate bodies and institutional members are eligible to become trading members in this segment. The minimum networth requirements for members is (a) individuals and registered firms Rs. 75 lakhs and (b) Corporate bodies Rs. 100 lakh.

TRADING SYSTEM : There are separate trading systems for both WDM and CM segments. Let us discuss the two in detail.

Capital Market Segment : The NSE market is fully automated screen-based trading system which adopts the principle of an order driven market. It provides complete flexibility to members in the kinds of orders that can be placed by them. Orders, as and when they are received, are first time stamped and then immediately processed for potential match.

Order matching rules of NSE System : The best buy order match with the best sell order. Members can proactively enter orders in the system which is displayed in the system till another party expresses interest in that order and puts a counter order, alternatively, members may be reactive and put in orders that match with existing orders on the system.

Order types and conditions : The trading members can enter various types of orders depending upon his/her requirements. These conditions are broadly of three categories: time-related, price-related and volume-related conditions.

Wholesale Debt Market Segment : The full computerized, online trading system has changed the very manner in which trading is perceived in the Indian Stock Market. Besides the fact, that the system has increased trading velocities and cut timeframes.
The trading system provides tremendous flexibility to the users in terms of the type of orders that can be placed on the system. Detailed information on the total order depth in a security, the best buys and sells available in the market, the quantity traded in that security, the high, the low and last traded price is available through the various market screens at all point of time.

CLEARING AND SETTLEMENT SYSTEM OF NSE :

Trading has grown rapidly at NSE, due to short and tight settlement cycles which the NSE operates as per a well defined schedule so that investors are assured of settlement.
Settlement Features of Capital Market Segment : The cycles are short and announced well in advance by the NSE. All scrip are handled by the Clearing House. The gap between fund pay-in and pay-out is only one day. The NSE takes responsibility for rectifying short or bad deliveries and objections by initiating auction buy-in. It assures legal guarantee of transactions and settlement of the NSE.
NSE operates on account period for a periodic settlement cycle. Trading period starts on Wednesday and ends on Tuesday of the next week. All trades concluded during a particular period are settled during the next week. At the end of a trading period of the NSE, it multilaterally net obligations and generates delivery statements for members. Securities are paid in on the Monday following the trading period. Funds are paid in on Tuesday. The payout day for both funds and securities is Wednesday. Thus, settlement is completed in eight days from the end of the last day of the trading cycle.

The clearing system is automated. Settlement is on a physical basis requiring the delivery and receipt of documents. The NSE has set up a clearing house, namely, National Securities Clearing Corporation Ltd. (NSCCL) for managing settlement of securities.
Institutional Market Segment : *Two additional market segments have also been set up exclusively for institutions – Institutional Lot (IL) and Trade for Trade (TT) segment. The objective behind the IL segment is to initiate an institutional market where large volume trades take place in institutional board lots. Likewise, TT is meant to cater to institutions who prefer trade for trade settlement as a means of minimizing exposure risks.*

Settlement Features of WDM Segment : The primary responsibility of settling trades concluded in the WDM segment rests directly with the participants and the exchange monitors the settlements. These trades are settled in Mumbai as per the defined procedure. NSE closely monitors the settlement of transactions through the reporting of settlement details by members and participants. In case of deferment of settlement or cancellation of trade, participants are required to seek its prior approval. For any dispute arising in respect of the trades or settlement, the NSE has established arbitration mechanism for resolving the same.

LESSON 38
WORKING OF MAIN STOCK EXCHANGES IN INDIA

Lesson Objectives: **To understand the trading activity at major stock exchanges in India namely : Bombay Stock Exchange, National Stock Exchange and Over The Counter Stock Exchange.**

Dear Students, to understand the capital market properly you must know how the stock market operations take place. Hence it is required that you collect information about the working of various stock exchanges in the country.

All the students are divided into three groups and each group is required to make a presentation on working/trading activity of one stock exchange. The other groups are expected to cross examine the presentation.

LESSON 39
CREDIT RATING: AN INTRODUCTION

Lesson Objectives: **To understand the concept of credit rating,**
Advantages and disadvantages of credit rating,
Credit rating indicators, terminology
Government and SEBI regulations related to credit rating activity.

INTRODUCTION

With the increasing market orientation of the Indian economy, investors value a systematic assessment of two types of risks, namely "business risk" arising out of the "open economy" and linkages between money, capital and foreign exchange markets and "payments risk". With a view to protect small investors, who are the main target for unlisted corporate debt in the form of fixed deposits with companies, credit rating has been made mandatory.

India was perhaps the first amongst developing countries to set up a credit rating agency in 1988. The function of credit rating was institutionalised when RBI made it mandatory for the issue of Commercial Paper (CP) and subsequently by SEBI. when it made credit rating compulsory for certain categories of debentures and debt instruments. In June 1994, RBI made it mandatory for Non-Banking Financial Companies (NBFCs) to be rated. Credit rating is optional for Public Sector Undertakings (PSUs) bonds and privately placed non-conve11ible debentures upto Rs. 50 million. Fixed deposits of manufacturing companies also come under the purview of optional credit rating.

ORIGIN

The first mercantile credit agency was set up in New York in 1841 to rate the ability of merchants to pay their financial obligations. Later on, it was taken over by Robert Dun. This agency published its first rating guide in 1859. The second agency was established by John Bradstreet in 1849 which was later merged with first agency to form Dun & Bradstreet in 1933, which became the owner of Moody's Investor's Service in 1962. The history of Moody's can be traced back about a 100 years ago. In 1900, John Moody laid stone of Moody's Investors Service and published his 'Manual of Railroad Securities'.

Early 1920's saw the expansion of credit rating industry when the Poor's Publishing Company published its first rating guide in 1916. Subsequently Fitch Publishing Company and Standard Statistics Company were set up in 1924 and 1922 respectively. Poor and Standard merged together in 1941 to form Standard and Poor's which was subsequently taken over by McGraw Hill in 1966. Between 1924 and 1970, no major new rating agencies were set up. But since 1970's, a number of credit

rating agencies have been set up all over the world including countries like Malaysia, Thailand, Korea, Australia, Pakistan and Philippines etc. In India, CRISIL (Credit Rating and Information Services of India Ltd.) was setup in 1987 as the first rating agency followed by ICRA Ltd. (formerly known as Investment Information & Credit Rating Agency of India Ltd.) in 1991, and Credit Analysis and Research Ltd. (CARE) in 1994. All the three agencies have been promoted by the All-India Financial Institutions. The rating agencies have established their creditability through their independence, professionalism, continuous research, consistent efforts and confidentiality of information. Duff and Phelps has tied up with two Indian NBFCs to set up Duff and Phelps Credit Rating India (P) Ltd. in 1996.

Meaning and Definition:

Credit rating is the opinion of the rating agency on the relative ability and willingness of tile issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. Symbols are simple and easily understood tool which help the investor to differentiate between debt instruments on the basis of their underlying credit quality. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding.

In other words, the rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. The rating measures the probability that the issuer will default on the security over its life, which depending on the instrument may be a matter of days to thirty years or more.

In fact, the credit rating is a symbolic indicator of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated. It can also be defined as an expression, through use of symbols, of the opinion about credit quality of the issuer of security/instrument.

Importance of Credit Rating:

Credit ratings establish a link between risk and return. They thus provide a yardstick against which to measure the risk inherent in any instrument. An investor uses the ratings to assess the risk level and compares the offered rate of return with his expected rate of return (for the particular level of risk) to optimise his risk-return trade-off.

The risk perception of a common investor, in the absence of a credit rating system, largely depends on his familiarity with the names of the promoters or the collaborators. It is not feasible for the corporate issuer of a debt instrument to offer every prospective investor the opportunity to undertake a detailed risk evaluation. It is very uncommon for different classes of investors to arrive at some uniform conclusion as to the relative quality of the instrument. Moreover they do not possess the requisite skills of credit evaluation.

Thus, the need for credit rating in today's world cannot be over-emphasised. It is of great assistance to the investors in making investment decisions. It also helps the issuers of the debt instruments to price their issues correctly and to reach out to new investors. Regulators like Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) use credit rating to determine eligibility criteria for some instruments. For example, the RBI has stipulated a minimum credit rating by an approved agency for issue of commercial paper. In general, credit rating is expected to improve quality consciousness in the market and establish over a period of time, a more meaningful relationship between the quality of debt and the yield from it. Credit Rating is also a valuable input in establishing business relationships of various types. However, credit rating by a rating agency is not a recommendation to purchase or sale of a security.

Investors usually follow security ratings while making investments. Ratings are considered to be an objective evaluation of the probability that a borrower will default on a given security issue, by the investors. Whenever a security issuer makes late payment, a default occurs. In case of bonds, non-payment of either principal or interest or both may cause liquidation of a company. In most of the cases, holders of bonds issued by a bankrupt company receive only a portion of the amount invested by them.

Thus, credit rating is a professional opinion given after studying all available information at a particular point of time. Such opinions may prove wrong in the context of subsequent events. Further, there is no private contract between an investor and a rating agency and the investor is free to accept or reject the opinion of the agency. Thus, a rating agency cannot be held responsible for any losses suffered by the investor taking investment decision on the basis of its rating. Thus, credit rating is an investor service and a rating agency is expected to maintain the highest possible level of analytical competence and integrity. In the long run, the credibility of rating agency has to be built, brick by brick, on the quality of its services provided, continuous research undertaken and consistent efforts made.

The increasing levels of default resulting from easy availability of finance, has led to the growing importance of the credit rating. The other factors are:

(i) The growth of information technology.
(ii) Globalisation of financial markets.
(iii) Increasing role of capital and money markets.
(iv) Lack of government safety measures.
(v) The trend towards privatisation.
(vi) Securitisation of debt.

Indications of the Assigned Ratings

Rating symbols assigned to a security issue is an indicator of the following:

(i) the nature and terms of the particular security being issued;
(ii) the ability and the willingness of the issuer of a security to make payments in time;
(iii) the probability that the issuer will make a default in payments; and
(iv) the degree of protection available to the investors if the security issuer company is liquidated, re-organised or declared bankrupt.

Factors Affecting Assigned Ratings:

The following factors generally influence the ratings to be assigned by a credit rating agency:

(1) The security issuer's ability to service its debt. In order, they calculate the past and likely future cash flows and compare with fixed interest obligations of the issuer.
(2) The volume and composition of outstanding debt.
(3) The stability of the future cash flows and earning capacity of company.
(4) The interest coverage ratio i.e. how many number of times the issuer is able to meet its fixed interest obligations.
(5) Ratio of current assets to current liabilities (i.e. current ratio (CR)) is calculated to assess the liquidity position of the issuing firm.
(6) The value of assets pledged as collateral security and the security's priority of claim against the issuing firm's assets.
(7) Market position of the company products is judged by the demand for the products, competitors market share, distribution channels etc.
(8) Operational efficiency is judged by capacity utilisation, prospects of expansion, modernisation and diversification, availability of raw material etc.
(9) Track record of promoters, directors and expertise of staff also affect the rating of a company.

Nature of Credit Rating:

(1) Rating is based on information: Any rating based entirely on published information has serious limitations and the success of a rating agency will depend, to a great extent, on its ability to access privileged information. Cooperation from the issuers as well as their willingness to share even confidential information are important pre-requisites. The rating agency must keep information of confidential nature possessed during the rating process, a secret.
(2) Many factors affect rating: Rating does not come out of a predetermined mathematical formula. Final rating is given taking into account the quality of management, corporate strategy, economic outlook and international environment. To ensure consistency and reliability a number of qualified professionals are involved in the rating process. The Rating Committee, which assigns the final rating, consists of specialised financial and credit analysts. Rating agencies also ensure that the rating process is free from any possible clash of interest.
(3) Rating by more than one agency: In the well developed capital markets, debt issues are, more often than not, rated by more than one agency. And it is only natural that ratings given by two or more agencies differ from each other e.g., a debt issue, may be rated 'AA+' by one agency and 'AA' or 'AA-' by another. It will indeed be unusual if one agency assigns a rating of AA while another gives a 'BBB'.
(4) Monitoring the already rated issues: A rating is an opinion given on the basis of information available at particular point of time. Many factors may affect the debt servicing capabilities of the issuer. It is, therefore, essential that rating agencies monitor all outstanding debt issues rated by them as part of their investor service. The rating agencies should put issues under close credit

watch and upgrade or downgrade the ratings as per the circumstances after intensive interaction with the issuers.

(5) Publication of ratings: In India, ratings are undertaken only at the request of the issuers and only those ratings which are accepted by the issuers are published. Thus, once a rating is accepted it is published and subsequent changes emerging out of the monitoring by the agency will be published even if such changes are not found acceptable by the issuers.

(6) Right of appeal against assigned rating: Where an issuer is not satisfied with the rating assigned, he may request for a review, furnishing additional information, if any, considered relevant. The rating agency will undertake a review and thereafter give its final decision. Unless the rating agency had over looked critical information at the first stage chances of the rating being changed on appeal are rare.

(7) Rating of rating agencies: Informed public opinion will be the touchstone on which the rating companies have to be assessed and the success of a rating agency is measured by the quality of the services offered, consistency and integrity.

(8) Rating is for instrument and not for the issuer company: The important thing to note is that rating is done always for a particular issue and not for a company or the Issuer. It is quite possible that two instruments issued by the same company carry different ratings, particularly if maturities are substantially different or one of the instruments is backed by additional credit reinforcements like guarantees. In many cases, short-term obligations, like commercial paper (CP) carry the highest rating even as the risk profile changes for longer maturities.

(9) Rating not applicable to equity shares: By definition, credit rating is an opinion on the issuers capacity to service debt. In the case of equity there is no pre-determined servicing obligation, as equity is in the nature of venture capital. So, credit rating does not apply to equity shares.

(10) Credit vs. financial analysis: Credit rating is much broader concept than financial analysis. One important factor which needs consideration is that the rating is normally done at the request of and with the active co-operation Of the issuer. The rating agency has access to unpublished information and the discussions with the senior management of issuers give meaningful insights into corporate plans and strategies. Necessary adjustments are made to the published accounts for the purpose of analysis. Rating is carried out by specialised professionals who are highly qualified and experienced. The final rating is assigned keeping in view the number of factors.

(11) Time taken in rating process: The rating process is a fairly detailed exercise. It involves, among other things analysis of published financial information, visits to the issuers offices and works, 'intensive discussion with the senior executives of issuers, discussions with auditors, bankers, creditors etc. It also involves an in-depth study of the industry itself and a degree of environment scanning. All this takes time, a rating agency may take 6 to 8 weeks or more to arrive at a decision. For rating short-term instruments like commercial paper (CP), the time taken may vary from 3 to 4 weeks, as the focus will be more on short-term liquidity rather than on long-term fundamentals. Rating agencies do not compromise on the quality of their analysis or work under pressure from

issuers for quick results. Issuers are always advised to. approach the rating agencies sufficiently in advance so that issue schedules can be adhered to.

Instruments for Rating:

Rating may be carried out by the rating agencies in respect of the following:

(i) Equity shares issued by a company.
(ii) Preference shares issued by a company.
(iii) Bonds/debentures issued by corporate, government etc.
(iv) Commercial papers issued by manufacturing companies, finance companies, banks and financial institutions for raising sh0l1-term loans.
(v) Fixed deposits raised for medium-term ranking as unsecured borrowings.
(vi) Borrowers who have borrowed money.
(vii) Individuals.
(viii) Asset backed securities are assessed to determine the risk associated with them. The objective is to determine quantum of cash flows emerging from the asset that would be sufficient to meet committed payments.

Rating other than debt instruments:

Credit Rating has been extended to all those activities where uncertainty and risk is involved. Now-a-days credit rating is not just limited to debts instruments but also covers the following:

I. Country Rating.

A country may be rated whenever a loan is to be extended or some major investment is to be made in it by international investors to determine the safety and security of their investments. A number of factors such as growth rate, industrial and agricultural production, government policies, inflation, fiscal deficit etc. are taken into consideration to arrive at such rating. Any upgrade movement in such--ratings has a positive impact on the stock markets. Morgan Stanlay, Moodys etc. give country ratings.

II. Rating of Real Estate Builders & Developers

CRISIL has started assigning rating to the builders and developers with the objective of helping and guiding prospective real estate buyers. CRISIL thoroughly scrutinises the sale deed papers, sanctioned plan, lawyers' report government clearance certificates before assigning rating to the builder or developer. Past experience of the builder, number of properties built by the builder, financial strength, time taken for completion are some of the factors taken into consideration by the CRISIL before giving a final rating to the real estate builder/developer.

III. Chit Funds

Chit funds registered as a company are sometimes rated on their ability to make timely payment of prize money to subscribers. The rating helps the chit funds in better marketing of their fund and in widening of the subscribers base. This service is provided by CRISIL.

IV. Rating of States

States of India have also approached rating agencies for rating. Rating helps the State to attract investors both from India and abroad to make investments. Investors find safety of their funds while investing in a state with good rating. Foreign

companies also come forward and set up projects in such states with positive rating. Rating agencies take into account various economic parameters such as industrial and agricultural growth of the State, availability of raw material, labor etc. and political parties agenda with respect to industry, labor etc., relation between Centre and State and freedom enjoyed by the states in taking decisions while assigning final rating to the states. States like Maharashtra, Madhya Pradesh, Tamil Nadu, Andhra Pradesh and Kerala have already been rated by CRISIL.

V. Rating of Banks

CRISIL and ICRA both are engaged in rating of banks based on the following six parameters also called CAMELS.

C - C stands for capital adequacy of banks. A bank need to maintain at least 10 % capital against risky assets of the bank.

A - A stands for asset quality. The loan is examined to determine non-performing assets. An asset/loan is considered non-performing asset where either interest or principal is unpaid for two quarters or more. Ratios like NPA to Net Advances, Adequacy of Provision & Debt Service Coverage Ratio are also calculated to know exact picture of quality of asset of a bank.

M - M stands for management evaluation. Here, the efficiency and effectiveness of management in framing plans and policies is examined. Ratios like RO!, Return on Capital Employed (ROC E), Return on Assets (ROA) are calculated to comment upon bank's efficiency to utilise the assets.

L - L indicates liquidity position. Liquid and current ratios are determined to find out banks ability to meet its short-term claims.

S - S stands for Systems and Control. Existing systems are studied in detail to determine their adequacy and efficacy.

Thus, the above six parameters are analysed in detail by the rating agency and then final rating is given to a particular bank. Ratings vary from A to D. Where A denotes financial, managerial and operational soundness of a bank, and D denotes that bank is in financial crisis and lacks managerial expertise and is facing operational problems.

VI. Rating (Recommendation) for Equities

These days analysts specialised in equity ratings make a forecast of the stock prices of a company. They study thoroughly the trend of sales, operating profits and other variables and make a forecast of the earning capacity and profitability position of a company. They use financial statement analysis tools like ratio analysis, trend analysis, fund flow analysis and cash flow analysis to comment upon company's liquidity, solvency, profitability and overall efficiency position. Analysts suggests a target price of the stock giving signal to the investor to swing into action whenever the stock hits that particular price. The following are some of the recommendations made by the equity analysts for its investors:

(i) Buy: It shows the stock is worth buying at its current price.

(ii) Buy on Declines: This recommendation indicates stock is basically good but overpriced now. The investor should go for buying whenever the price declines.

(iii) Long-term Buy: This recommendation suggests that a stock should be bought and held for a longer period at least a year in order to realise gains.

(iv) Strong Buy: This buy recommendation strongly favors the purchase of a stock because analysts expect a steep rise in the prices of stock from its current price.

(v) Out-performer: This recommendation shows that whatever may be the mood of the stock market the stock will perform better than the market.

(vi) Overweight: This refers to that investor can increase the quantum or weight of that stock in his portfolio. This recommendation is applicable to those investors who keep number of stocks in their portfolio.

(vii) Hold: This recommendation is a suggestion to the investor to exit because stock prices are not likely to be appreciated significantly from the current price level.

(viii) Sell/Dispose/Sub-Standard/Under-weight: It indicates to the investor to sell/dispose off or decrease the weight of stock from its portfolio because stock is fundamentally overvalued at its current level and the investor' should exit from it immediately.

Functions of a Credit Rating Agency:

A credit rating agency serves following functions:

(1) Provides unbiased opinion: An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:

(i) It has no vested interest in an issue unlike brokers, financial intermediaries.

(ii) Its own reputation is at stake.

(2) Provides quality and dependable information:. A credit rating agency is in a position to provide quality information on credit risk which is more authenticate and reliable because:

(i) It has highly trained and professional staff who has better ability to assess risk.

(ii) It has access to a lot of information which may not be publicly available.

(3) Provides information at low cost: Most of the investors rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of negligible price. It is not possible for the investors to assess the creditworthiness of the companies on their own.

(4) Provide easy to understand information: Rating agencies first of all gather information, then analyse the same. At last these interpret and summarise complex information in a simple and readily understood formal manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.

(5) Provide basis for investment: An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.

(6) Healthy discipline on corporate borrowers: Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/discipline on corporate.

(7) Formation of public policy: Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional port-folio.

ADVANTAGES OF CREDIT RATING

Different benefits accrue from use of rated instruments to different class of investors or the company. These are explained as under:

A. Benefits to Investors

(1) Safety of investments. Credit rating gives an idea in advance to the investors about the degree of financial strength of the issuer company. Based on rating he decides about the investment. Highly rated issues gives an assurance to the investors of safety of Investments and minimizes his risk.

(2) Recognition of risk and returns. Credit rating symbols indicate both the returns expected and the risk attached to a particular issue. It becomes easier for the investor to understand the worth of the issuer company just by looking at the symbol because the issue is backed by the financial strength of the company.

(3) Freedom of investment decisions. Investors need not seek advise from the stock brokers, merchant bankers or the portfolio managers before making investments. Investors today are free and independent to take investment decisions themselves. They base their decisions on rating symbols attached to a particular security. Each rating symbol assigned to a particular investment suggests the creditworthiness of the investment and indicates the degree of risk involved in it.

(4) Wider choice of investments. As it is mandatory to rate debt obligations for every issuer company, at any particular time, wide range of credit rated instruments are available for making investment. Depending upon his own ability to bear risk, the investor can make choice of the securities in which investment is to be made.

(5) Dependable credibility of issuer. Absence of any link between the rater and rated firm ensures dependable credibility of issuer and attracts investors. As rating agency has no vested interest in issue to be rated, and has no business connections or links with the Board of Directors. In other words, it operates independent of the issuer company, the rating given by it is always accepted by the investors.

(6) Easy understanding of investment proposals. Investors require no analytical knowledge on their part about the issuer company. Depending upon rating symbols assigned by the rating agencies they can proceed with decisions to make investment in any particular rated security of a company.

(7) Relief from botheration to know company. Credit agencies relieve investors from botheration of knowing the details of the company, its history, nature of business, financial position, liquidity and profitability position, composition of management staff and Board of Directors etc. Credit rating by professional and specialised analysts reposes confidence in investors to rely upon the credit symbols for taking investment decisions.

(8) Advantages of continuous monitoring. Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency

downgrades or upgrades the rating symbols following the decline or improvement in the financial position respectively.

B. Benefits of Rating to the Company

A company who has got its credit instrument or security rated is benefited in the following ways.

(1) Easy to raise resources. A company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to a particular security but they still get attracted towards the highly rated instruments.

(2) Reduced cost of borrowing. Investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return. A company can reduce the cost of borrowings by quoting lesser interest on those fixed deposits or debentures or bonds, which are highly rated.

(3) Reduced cost of public issues. A company with highly rated instruments has to make least efforts in raising funds through public. It can reduce its expenditure on press and publicity. Rating facilitates best pricing and timing of issues.

(4) Rating builds up image. Companies with highly rated instrument enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors. Customers feel confident of the quality of goods manufactured, shareholders are sure of high returns, investors feel secured of their investments and creditors are assured of timely payments of interest and principal.

(5) Rating facilitates growth. Rating motivates the promoters to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future. Moreover highly rated companies find it easy to raise funds from public through new issues or through credit from banks and FIs to finance their expansion activities.

(6) Recognition to unknown companies. Credit rating provides recognition to relatively unknown companies going for public issues through wide investor base. While entering into market, investors rely more on the rating grades than on 'name recognition'.

C. Benefits to Intermediaries

Stock brokers have to make less efforts in persuading their clients to select an investment proposal of making investment in highly rated instruments. Thus rating enables brokers and other financial intermediaries to save time, energy costs and manpower in convincing their clients.

DISADVANTAGES OF CREDIT RATING

Credit rating suffers from the following limitations

(1) Non-disclosure of significant information. Firm being rated may not provide significant or material information, which is likely to affect the investor's decision as to investment, to the investigation team of the credit rating

company. Thus any decisions taken in the absence of such significant information may put investors at a loss.

(2) Static study. Rating is a static study of present and past historic data of the company at one particular point of time. Number of factors including economic, political, environment, and government policies have direct bearing on the working of a company. Any changes after the assignment of rating symbols may defeat the very purpose of risk indicativeness of rating.

(3) Rating is no certificate of soundness. Rating grades by the rating agencies are only an opinion about the capability of the company to meets its interest obligations. Rating symbols do not pinpoint towards quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.

(4) Rating may be biased. Personal bias of the investigating team might affect the quality of the rating. The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such a case the investors cannot get the true information about the risk involved in the instrument.

(5) Rating under unfavorable conditions. Rating grades are not always representative of the true image of a company. A company might be given low grade because it was passing through unfavorable conditions when rated. Thus, misleading conclusions may be drawn by the investors which hampers the company's interest.

(6) Difference in rating grades. Same instrument may be rated differently by the two rating agencies because of the personal judgment of the investigating staff on qualitative aspects. This may further confuse the investors.

LESSON 41
CREDIT RATING: THE PROCESS

Lesson Objectives: **To understand the process of credit rating, mechanism of credit rating,**

CREDIT RATING PROCESS

The rating process begins with the receipt of formal request from a company desirous of having its issue obligations rated by credit rating agency. A credit rating agency constantly monitors all ratings with reference to new political, economic and financial developments and industry trends. The process/procedure followed by all the major credit rating agencies in the country is almost similar and usually comprises of the following steps.

(1) Receipt of the request: The rating process begins, with the receipt of formal request for rating from a company desirous of having its issue obligations under proposed instrument rated by credit rating agencies. An agreement is entered into between the rating agency and the issuer company.

The agreement spells out the terms of the rating assignment and covers the following aspects:

(i) It requires the CRA (Credit Rating Agency) to keep the information confidential.
(ii) It gives right to the issuer company to accept or not to accept the rating.
(iii) It requires the issuer company to provide all material information to the CRA for rating and subsequent surveillance.

(2) Assignment to analytical team: On receipt of the above request, the CRA assigns the job to an analytical team. The team usually comprises of two members/analysts who have expertise in the relevant business area and are responsible for carrying out the rating assignments.

(3) Obtaining information:. The analytical team obtains the requisite information from the client company. Issuers are usually provided a list of information requirements and broad framework for discussions. These requirements are derived from the experience of the issuers business and broadly confirms to all the aspects which have a bearing on the rating. The analytical team analyses the information relating to its financial statements, cash flow projections and other relevant information.

(4) Plant visits and meeting with management: To obtain classification and better understanding of the client's operations, the team visits and interacts with the company's executives. Plants visits facilitate understanding of the production process, assess the state of equipment and main facilities, evaluate the quality of technical personnel and form an opinion on the key variables that influence level, quality and cost of production.

A direct dialogue is maintained with the issuer company as this enables the CRAs to incorporate non-public information in a rating decision and also enables the rating' to be forward looking. The topics discussed during the management meeting are wide ranging including competitive position, strategies, financial policies, historical performance, risk profile and strategies in addition to reviewing financial data.

(5) Presentation of findings: After completing the analysis, the findings are discussed at length in the Internal Committee, comprising senior analysts of the credit rating agency. All the issue having a bearing on rating are identified. An opinion on the rating is also formed. The findings of the team are finally presented to Rating Committee.
(6) Rating committee meeting: This is the final authority for assigning ratings. The rating committee meeting is the only aspect of the process in which the issuer does not participate directly. The rating is arrived at after composite assessment of all the factors concerning the issuer, with the key issues getting greater attention. '
(7) Communication of decision: The assigned rating grade is communicated finally to the issuer along with reasons or rationale supporting the rating. The ratings which are not accepted are either rejected or reviewed in the light of additional facts provided by the issuer. The rejected ratings are not disclosed and complete confidentiality is maintained.
(8) Dissemination to the public: Once the issuer accepts the rating, the credit rating agencies disseminate it through printed reports to the public.
(9) Monitoring for possible change: Once the company has decided to use the rating, CRAs are obliged to monitor the accepted ratings over the life of the instrument. The CRA constantly monitors all ratings with reference to new political, economic and financial developments and industry trends. All this information is reviewed regularly to find companies for ,major rating changes. Any changes in the rating are made public through published reports by CRAs.

RATING METHODOLOGY

Rating methodology used by the major Indian credit rating agencies is more or less the same. The rating methodology involves an analysis of all the factors affecting the creditworthiness of an issuer company e.g. business, financial and industry characteristics, operational efficiency, management quality, competitive position of the issuer and commitment to new projects etc. A detailed analysis of the past financial statements is made to assess the performance and to estimate the future earnings. The company's ability to service the debt obligations over the tenure of the instrument being rated is also evaluated. In fact, it is the relative comfort level of the issuer to service obligations that determine the rating. While assessing the instrument, the following are the main factors that are analysed into detail by the credit rating agencies.

1. Business Risk Analysis
2. Financial Analysis
3. Management Evaluation
4. Geographical Analysis
5. Regulatory and Competitive Environment 6. Fundamental Analysis

These are explained as under:

I. Business Risk Analysis

Business risk analysis aims at analysing the industry risk, market position of the company, operating efficiency and legal position of the company. This includes an analysis of industry risk, market position of the company, operating efficiency of the company and legal position of the company.

(a) Industry risk: The rating agencies evaluates the industry risk by taking into consideration various factors like strength of the industry prospect, nature and

basis of competition, demand and supply position, structure of industry, pattern of business cycle etc. Industries compete with each other on the basis of price, product quality, distribution capabilities etc. Industries with stable growth in demand and flexibility in the timing of capital outlays are in a stronger position and therefore enjoy better credit rating.

(b) Market position of the company: Rating agencies evaluate the market standing of a company taking into account:
   (i) Percentage of market share
   (ii) Marketing infrastructure
   (iii) Competitive advantages
   (iv) Selling and distribution channel
   (v) Diversity of products
   (vi) Customers base
   (vii) Research and development projects undertaken to identify obsolete products
   (viii) Quality Improvement programs etc.

(c) Operating efficiency: Favorable locational advantages, management and labor relationships, cost structure, availability of raw-material, labor, compliance to pollution control programs, level of capital employed and technological advantages etc. affect the operating efficiency of every issuer company and hence the credit rating.

(d) Legal position: Legal position of a debt instrument is assessed by letter of offer containing terms of issue, trustees and their responsibilities, mode of payment of interest and principal in time, provision for protection against fraud etc.

(e) Size of business: The size of business of a company is a relevant factor in the rating decision. Smaller companies are more prone to risk due to business cycle changes as compared to larger companies. Smaller companies operations are limited in terms of product, geographical area and number of customers. Whereas large companies enjoy the benefits of diversification owing to wide range of products, customers spread over larger geographical area.

Thus, business analysis covers all the important factors related to the business operations over an issuer company under credit assessment.

II. Financial Analysis

Financial analysis aims at determining the financial strength of the issuer company through ratio analysis, cash flow analysis and study of the existing capital structure. This includes an analysis of four important factors namely:

(a) Accounting quality
(b) Earnings potential/profitability
(c) Cash flows analysis
(d) Financial flexibility

Financial analysis aims at determining the financial strength of the issuer company through quantitative means such as ratio analysis. Both past and current performance is evaluated to comment the future performance of a company. The areas considered are explained as follows.

(a) Accounting quality: As credit rating agencies rely on the audited financial statements, the analysis of statements begins with the study of accounting quality. For the purpose, qualification of auditors, overstatement/understatement

of profits, methods adopted for recognising income, valuation of stock and charging depreciation on fixed assets are studied.

(b) Earnings potential/profitability: Profits indicate company's ability to meet its fixed interest obligation in time. A business with stable earnings can withstand any adverse conditions and also generate capital resources internally. Profitability ratios like operating profit and net profit ratios to sales are calculated and compared with last 5 years figures or compared with the similar other companies carrying on same business. As a rating is a forward-looking exercise, more emphasis is laid on the future rather than the past earning capacity of the issuer.

(c) Cash flow analysis: Cash flow analysis is undertaken in relation to debt and fixed and working capital requirements of the company. It indicates the usage of cash for different purposes and the extent of cash available for meeting fixed interest obligations. Cash flows analysis facilitates credit rating of a company as it better indicates the issuer's debt servicing capability compared to reported earnings.

(d) Financial flexibility: Existing Capital structure of a company is studied to find the debt/equity ratio, alternative means of financing used to raise funds, ability to raise funds, asset deployment potential etc. The future debt claims on the issuer's as well as the issuer's ability to raise capital is determined in order to find issuer's financial flexibility.

III. Management Evaluation

Any company's performance is significantly affected by the management goals, plans and strategies, capacity to overcome unfavorable conditions, staff's own experience and skills, planning and control system etc. Rating of a debt instrument requires evaluation of the management strengths and weaknesses.

IV. Geographical Analysis

Geographical analysis is undertaken to determine the locational advantages enjoyed by the issuer company. An issuer company having its business spread over large geographical area enjoys the benefits of diversification and hence gets better credit rating. A company located in backward area may enjoy subsidies from government thus enjoying the benefit of lower cost of operation. Thus geographical analysis is undertaken to determine the locational advantages enjoyed by the issuer company.

V. Regulatory and Competitive Environment

Credit rating agencies evaluate structure and regulatory framework of the financial system in which it works. While assigning the rating symbols, CRAs evaluate the impact of regulation/deregulation on the issuer company.

VI. Fundamental Analysis

Fundamental analysis includes an analysis of liquidity management, profitability and financial position, interest and tax rates sensitivity of the company. This includes an analysis of liquidity management, profitability and financial position, interest and tax rates sensitivity of the company.

1. Liquidity management involves study of capital structure, availability of liquid assets corresponding to financing commitments and maturing deposits, matching of assets and liabilities.
2. Asset quality covers factors like quality of company's credit risk management, exposure to individual borrowers and management of problem credits etc.
3. Profitability and financial position covers aspects like past profits, funds deployment, revenues on non-fund based activities, addition to reserves.
4. Interest and tax sensitivity reflects sensitivity of company following the changes in interest rates and changes in tax law.

Fundamental analysis is undertaken for rating debt instruments of financial institutions, banks and non-banking finance companies.

CREDIT RATING OF INSTRUMENTS

Credit rating is the process of assigning standard scores which summarize the probability of the issuer being able to meet its repayment obligations for a particular debt instrument in a timely manner. Credit rating is integral to debt markets as it helps market participants to arrive at quick estimates and opinions about various instruments. In this manner it facilitates trading in debt and money market instruments especially in instruments other than Government of India Securities.

Rating is usually assigned to a specific instrument rather than the company as a whole. In the Indian context, the rating is done at the instance of the issuer, which pays rating fees for this service. If it is unsatisfied with the rating assigned to its proposed instrument, it is at liberty not to disclose the rating given to it. There are 4 rating agencies in India. These are as follows:

CRISIL - The oldest rating agency was originally promoted by ICICI. Standard & Poor, the global leader in ratings, has recently taken a small 10% stake in CRISIL.

ICRA - Promoted by IFCI. Moody's, the other global rating major, has recently taken a small 11% stake in ICRA.

CARE - Promoted by IDBI.

Duff and Phelps - Co-promoted by Duff and Phelps, the world's 4th largest rating agency.

CRISIL is believed to have about 42% market share followed by ICRA with about 36%, CARE with 18% and Duff and Phelps with 4%.

Grading system

Each of the rating agencies has different codes for expressing rating for different instruments; however, the number of grades and sub-grades is similar eg for long term debentures/bonds and fixed deposits, CRISIL has 4 main grades and a host of sub-grades. In decreasing order of quality, these are AAA, AA+, AA, AA-, A+, A, A-, BBB-, BBB, BBB+, BB+, BB, BB-, B+, B, B-, C and D. ICRA, CARE and Duff and Phelps have similar grading systems. The following table contains a key to the codes used by CRISIL and ICRA.

Credit rating is a dynamic concept and all the rating companies are constantly reviewing the companies rated by them with a view to changing (either upgrading or downgrading) the rating. They also have a system whereby they keep ratings for particular companies on "rating watch" in case of major events, which may lead to change in rating in the near future. Ratings are made public through periodic newsletters issued by rating companies, which also elucidate briefly the rationale for particular ratings. In addition, they issue press releases to all major newspapers and wire services about rating events on a regular basis.

Factors involved in credit rating

Credit rating depends on several factors, some of which are tangible/numerical and some of which are judgmental and intangible. These factors are listed below:

- Overall fundamentals and earnings capacity of the company and volatility of the same
- Overall macro economic and business/industry environment
- Liquidity position of the company (as distinguished from profits)

- Requirement of funds to meet irrevocable commitments
- Financial flexibility of the company to raise funds from outside sources to meet temporary financial needs
- Guarantee/support from financially strong external bodies
- Level of existing leverage (borrowings) and financial risk

As mentioned earlier ratings are assigned to instruments and not to companies and two different ratings may be assigned to two different instruments of the same company eg a company may be in a fundamentally weak business and may have a poor rating assigned for 5 year debentures while its liquidity position may be good, leading to the highest possible rating for a 3 month commercial paper. Very few companies may be assigned the highest rating for a long term 5 or 7 year instrument eg CRISIL has only 20 companies rated as AAA for long term instruments and these companies include unquestionable blue chips like Videsh Sanchar Nigam, Bajaj Auto, Bharat Petroleum, Nestle India apart from institutions like ICICI, IDBI, HDFC and SBI.

Derived ratings and structured obligations

Sometimes, debt instruments are so structured that in case the issuer is unable to meet repayment obligations, another entity steps in to fulfill these obligations. Sometimes there is a documented, concrete mechanism for recourse to the third party, while on other occasions the arrangement is loose. On such occasions, the debt instrument in question is said to be "credit enhanced" by a "structured obligation" and the rating assigned to the instrument factors in the additional safety mechanism. The extent of enhancement is a function of the rating of the "enhancer", the nature of the arrangement etc and usually there is a suffix to the rating which expresses symbolically that the rating is enhanced e.g. A bond backed by the guarantee of the Government of India may be rated AAA (SO) with the SO standing for structured obligation.

Limitations of credit rating - rating downgrades

Rating agencies all across the world have often been accused of not being able to predict future problems. In part, the problem lies in the rating process itself, which relies heavily on past numerical data and standard ratios with relatively lower usage of judgment and understanding of the underlying business or the country economics. Data does not always capture all aspects of the situation especially in the complex financial world of today. An excellent example of the meaningless over reliance on numbers is the poor country rating given to India. Major rating agencies site one of the reasons for this as the low ratio India’s exports to foreign currency indebtedness. This completely ignores two issues – firstly, India gets a very high quantum of foreign currency earnings through remittances from Indians working abroad and also services exports in the form of software exports which are not counted as "merchandise" exports. These two flows along with other "invisible" earnings accounted for almost US$11bn in FY 99. Secondly, since India has tight control on foreign currency transactions, there is very little error possible in the foreign currency borrowing figure. As against this, for a country like Korea, the figure for foreign currency borrowing increased by US$50bn after the exchange crisis began. This was on account of hidden forward liabilities through swaps and other derivative products.

In general, Indian rating agencies have lost some amount of their credibility in the last two years due to their inability to predict defaults in many companies, which they had rated quite highly. Sometimes, some of the agencies had an investment grade rating in place when the company in question had already defaulted to some of the fixed deposit holders. Further, rating agencies resorted to mass downgrading of 50-100 companies as a reaction to public criticism, which further eroded their credibility. The major reasons for these downgrades are as follows

Corporate earnings fell very sharply due to persistent recessionary conditions prevailing in the economy. Many of the corporate are in commodity sectors where fluctuations in selling prices of products can be very sharp - leading to complete erosion of profitability. This problem was compounded by the Asian crisis, which led to increased competition from cheap imports in many product categories.
Rating agencies substantially overestimated financial flexibility of corporate especially from traditional corporate houses. Much of the financial flexibility was implicit on raising money from new issues from the capital market, which has been impossible in the last 3 years.

In the case of finance companies, widespread defaults like CRB and tightening of regulations made it virtually impossible for them to raise money in any form. These finance companies had been in the habit of investing in longer term, illiquid assets by borrowing shorter term fixed deposits. When the flow of credit stopped, they faced liquidity problems. These were further compounded by defaults by some of the companies to which they had on lent money.
The experience is no different from the international scenario where reputed and highly experienced rating agencies like Standard & Poor (S&P) and Moody's were unable to predict the Asian crisis and had to face the embarrassment of seeing the credit rating of South Korea as a country go from A+ to BB+ in a short span of 3 months.

By and large, the rating is a very good estimate of the actual creditworthiness of the company; however, it is not able to predict extreme situations such as the ones described above, which are unlikely to have been predicted by most investors in any case. Investors should realize that a credit rating is not sacrosanct and that one has to do one's own due diligence and investigation before investing in any instrument. They should use the rating as a reference and a base point for their own effort. One good way of doing this is examining the behavior of the stock price in case the stock is listed. As a collective, the market is far smarter at predicting problems than any credit rating agency. Witness the sharp erosion in stock prices of companies much before their credit ratings were downgraded. Witness also the fact that foreign currency bonds from Indian issuers trade at yields lower than countries which have been rated higher by rating agencies.

Critical Factors Influencing Financing Decisions: Credit Rating

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This paper deals with the credit rating services in countries, such as Japan, the UK, the US, and traces the genesis of credit rating in India, in general, and CRISIL the credit rating agency in India in particular. It feels that with the growth in volume and depth of capital markets in India, the volume credit rating is bound to increase and thus boost the investors' confidence.

A prospective investor would naturally like an assessment of risk involved in his investment for enabling a proper evaluation of the risk return trade-off. Factors, such as lack of time, lack of knowledge of the process of security evaluation, lack of reliable information, etc., could leave any investor wishing for an agency which would provide an unbiased judgment of risks underlying the security. In the US, a number of investment advisory firms, such as Moody's Investor Services, Standard and Poor's (S&P), and Dun and Bradstreet make an ongoing study of thousands of securities floated by various corporations and publish periodically their. ratings of such securities. In India, the notorious defaults of certain well known companies and fly-by-night operators which ensued the stock market boom of 1985 led to the setting of the Credit Rating Information Services of India, Ltd (CRISIL) in 1988, entrusted with the important task of evaluating the creditworthiness of companies trying to tap the capital markets through the issue of debt instruments.

Credit rating is an issue-specific or security specific evaluation of the credit/ default risk associated with a security and it conveys to the investor an independent assessment of the borrower's expected capability and inclination to service the debt on the due dates. The following are descriptions of credit rating as given by a few well known rating agencies.

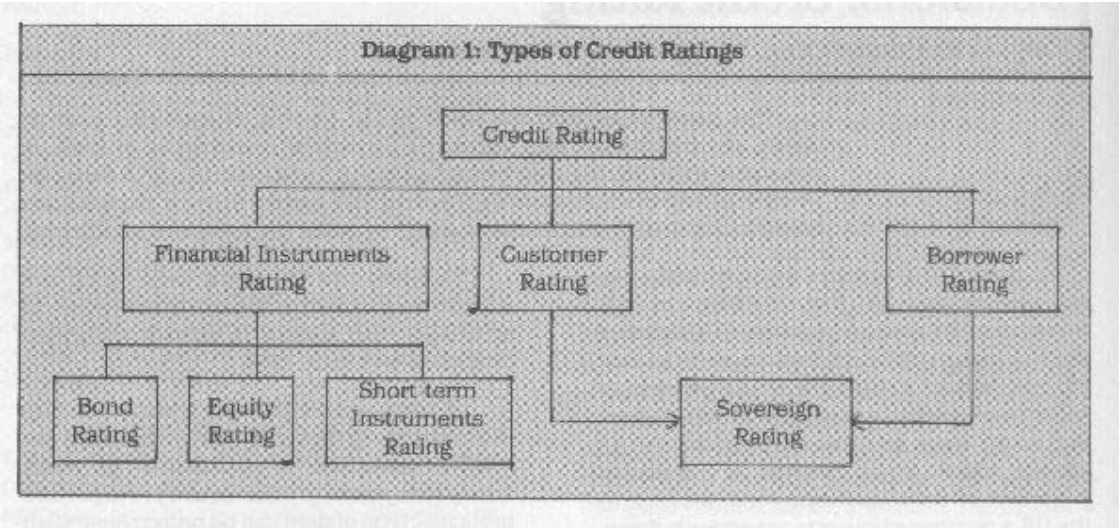
"Ratings are designed exclusively for the purpose of grading bonds according to their investment qualities (Moody's Investor Services, 1984)."
"Corporate or Municipal debt rating is a current assessment of the creditworthiness of an obligor with respect to specific obligation (Standard and Poor, 1984)."
"A corporate credit rating provides lenders with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted (Australian Ratings, 1984).

The above descriptions emphasize the use of credit rating to assess the probability of timely repayment of principal and interest by a borrower. It must also be noted that these descriptions associate credit rating with only debt or bond rating since credit rating by the very nature of the procedures adopted under it is more suitable for rating fixed income securities, such as debts or bonds on the basis of the default risk underlying them. Default risk, which is a major risk, accompanying the purchase of a fixed income security is that portion of total risk that results from changes in the financial integrity of the investment. Financial integrity changes when the company that has issued the security moves further away from or closer to bankruptcy. The weakening of the financial integrity of a firm triggers a fall in the prices of the firm's

securities, and usually the loss suffered by an investor on account of the fall in security prices will be higher than the losses suffered due to actual bankruptcy. The default risk is essentially determined by the amount of funds available to the issuer relative to the amount of funds required to be paid and as modified by the strength of the security owner's claim for payment (Francis, 1987).

Objectives and Benefits of Credit Rating

Diagram 1 depicts the various types of credit ratings that are usually done.



Bond rating refers to the rating of bonds or debt securities issued by a corporate, governmental or quasi governmental, body, such as rating of debentures, public sector bonds, municipal bonds, etc. Equity rating refers to the rating of equity shares issued by a company. Short-term instruments rating refers to the rating of short-term debt instruments, such as commercial papers issued by companies. Customer rating refers to the assessment of creditworthiness of a customer to whom credit sales are to be made. Borrower rating requires the assessment of the ability to repay of a borrower to whom a grant of loan is under consideration. If the customer or borrower is a country in which an investment is envisaged or to which a loan is to be given, the evaluation of the creditworthiness of such a country is referred to as sovereign rating.

The objectives of credit rating are: To (i) provide superior information to the ',investors at a low cost; (ii) provide a sound basis for proper risk return structure; (iii) subject borrowers to a healthy discipline; and (iv) assist in the framing of public policy guidelines on institutional investment.

A rating published by a professional agency is bound to provide superior information as the evaluation would be unbiased, the assessment thorough and in depth, and contain a lot of information not publicly available. Moreover, in terms of the time and efforts that would be required by an individual in gauging the risks associated with an instrument, a readily available score published by a reliable agency is bound to be cost-effective. Ultimately, since every published rating is a reflection of the agency's competence and integrity, the agency would provide ratings of high quality and reliability that would facilitate the investment process.

In an efficient market, the return earned on investments must match the risks associated with them. The availability of unbiased ratings would directly assist in the formation of such efficient capital markets. It has been observed in highly developed markets that bonds with higher ratings can offer lower rates of returns and those with lower rating have to offer higher rates of return. Also, as the rating of a bond declines, the market price starts falling, and this, in turn, pushes up the effective cost of the bond. A company whose instruments have been rated and published would follow rational and sound financial and business policies as the rating agency would keep a close watch on the company's management and would not hesitate to lower the ratings if the circumstances so warrant The government can also base its guidelines on the types of securities to be included in the various institutional portfolios on the ratings published by various agencies. In addition to these, credit rating can be used as a marketing tool for placement of debt obligations with the public and can provide increased liquidity in secondary markets.

It is also important to understand what purposes that debt or credit rating does not serve:

A rating is not a general overall evaluation of the issuing Organisation. If a security issued by a firm A is rated lower than a security floated by a firm B, it does not necessarily mean that firm A is worse off than firm B. Since credit ratings are security-specific, the rating assigned can be used only to study the default risk associated with the security and not for any other purpose.

A rating cannot be taken as a recommendation for purchasing, selling or holding of a security. Decisions to invest in securities must properly be based on (a) the expected rate of return, (b) the risks associated with the investment and (c) the risk profile of the investor. Of these three issues, credit rating only provides information on one of them, namely, the credit risk associated with the investment. Hence, rating cannot provide guidance for buying, selling or holding of securities.

A rating agency does not conduct a comprehensive audit of the operations of the issuing Organisation. Though the rating agency does make a complete study of the information made available by the company and tries to gather data on the various aspects of the business, it cannot certify that all the information provided by the company are true and fair.

A rating once issued by an agency does not remain valid for the entire life of the security. Whenever the risk characteristics of the security changes, the rating must be reviewed and upgraded or downgraded.

Most important of all, credit rating does not create a fiduciary relationship between the rating agency and the users of the ratings. There is no legal relationship between the agency and the user.

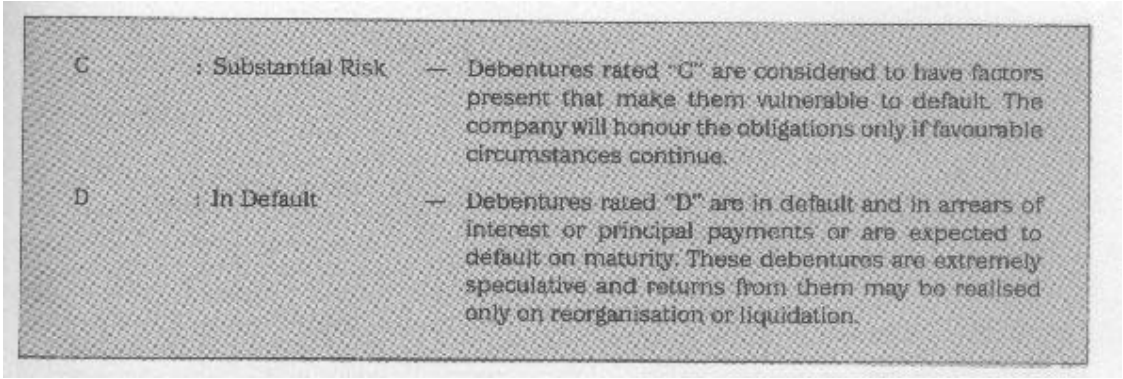
Credit Rating Information Services of India Ltd

The progressive liberalisation of economic policies which led to increased number of new projects being set up, coupled with the corporate sector's increasing dependence on primary markets for mobilisation of funds highlighted the need to set Up a credit rating agency in India. The year 1985 witnessed a phenomenal growth in the size of the capital market and an increasing number of players in both the primary and secondary markets. However, subsequent huge losses caused by investments in

ventures or which all claims had been made by the promoters resulted in the inventors shying away from the capital market. The Credit Rating Information Services of India Ltd (CRISIL) was set up in 1987 by ICICI, UTI, GIG, and LIC, with the major objective of restoring the confidence of the investors in the capital market and to provide unbiased assessment of the creditworthiness of companies issuing debt instruments. The other share-holders of CRISIL include the Asian Development Bank, the State Bank of India, the Mitsui Bank, the Bank of Tokyo, the Hong Kong and Shangai Banking Corporation, and the Housing Development Finance Corporation Ltd. (CRISIL, 198-). CRISIL commenced its operations in January 1988 and released its first rating in March 1988. As on September 1990, this agency had rated instruments of 28 manufacturing companies, and 21 finance companies (Economic Times, September 1990). The instruments rated by CRISIL include bonds, non convertible debentures, convertible debentures (valid till the time of conversion), debenture portion of equity linked debentures, fixed deposits, preference shares, and commercial papers (Keya Sarkar, 1987). So far, CRISIL has not taken up rating of equity shares.

Table 1: Rating of Debentures

High Investment Grades		
AAA (Triple A)	: Highest Safety	— Debentures rated "AAA" by CRISIL are considered to offer the highest safety of payment of interest and principal on time. Though the circumstances providing this degree of safety are likely to change, such changes are not likely to adversely affect the fundamentally strong position of such issues.
AA (Double A)	: High Safety	Debentures rated "AA" are considered to offer high safety of timely payment of interest and principal. They differ in safety from triple A issues only marginally.
Investment Grades		
A	: Adequate Safety	— Debentures rated "A" are considered to offer adequate safety of payment of interest and principal on time. However, any changes in circumstances can affect such issues more than those in the higher rated categories.
BBB (Triple B)	: Moderate Safety	— Debentures rated "BBB" are considered to offer sufficient safety of timely payment of interest and principal for the present. However, changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal than for debentures in higher rated categories.
Speculative Grades		
BB (Double B)	: Inadequate Safety	— Debentures rated "BB" are considered to carry inadequate safety of timely payment of interest and principal. While these debentures are less susceptible to default than other speculative grade debentures in the immediate future, the uncertainties that the issuer faces could lead to inadequate capacity to make timely interest and principal payments.
B	: High Risk	— Debentures rated "B" are considered to have greater susceptibility to default. Though the interest and principal payments are being met currently, adverse business or economic conditions would lead to lack of ability or willingness to honour obligations.



C	: Substantial Risk	—	Debentures rated "C" are considered to have factors present that make them vulnerable to default. The company will honour the obligations only if favourable circumstances continue.
D	: In Default	—	Debentures rated "D" are in default and in arrears of interest or principal payments or are expected to default on maturity. These debentures are extremely speculative and returns from them may be realised only on reorganisation or liquidation.

The rating process adopted by CRISIL culminates in the attaching of some specified symbols to the instruments. These symbols are designed to indicate, in a summary form, CRISIL's opinion regarding the relative safety of timely payment of interest and principal on the instruments. The instruments based on the symbols are divided into three broad categories: High investment grades; investment grades; and speculative grades. The symbols used for rating the debentures and the interpretation to be attached to the symbols are given in table 1. (CRISIL 198-). The symbols used in rating of other instruments are given in Appendix 1. CRISIL may apply +' (plus) or'-' (minus) signs for ratings from "AA" to "D" to reflect the comparative standing within the category. Different instruments of the same company could carry different ratings due to the different characteristics or features of the instruments and the different indenture provisions.

The rating process of CRISIL begins at the request of a company. An analytical team assigned the task of rating, obtains and analyses information, meets the company's management and also interacts with a back-up team which would have collected industry .information. The findings are submitted to a ratings committee, comprising certain directors who are not connected with any CRISIL share-holder, decides on the rating which is communicated to the company. If the company wishes to present some additional information, it can do so at this stage. The issuer can also appeal against the rating and ask for a review. If the additional information provided so warrant the rating will be reviewed and revised. During the rating process, strict confidentiality of client information is maintained and the board of directors of CRISIL does not get involved in the rating process nor does it know of what ratings are in progress. Moreover, once a company decides to use the rating, CRISIL is under an obligation to monitor the rating over the life of the instrument. CRISIL may change the rating depending upon new information or developments concerning the company and any change so effected is made public (CRISIL 198-). The rating process for a new issue is shown in diagram 2.

CRISIL considers the following key factors in its analysis. (CRISIL, 198-).
(a) Business analysis. This covers (i) industry risk (factors, such as nature and basis of competition; key success factors; demand supply position; structure of industry; government policies, etc.); (ii) market position of the company within the industry (factors, such as market share; competitive advantages; selling and distribution arrangements; product and consumer diversity, etc.); (iii) operating efficiency of the

company (factors, such as locational advantages; labour relationships; cost structure and manufacturing efficiency, compared to those of competitors, etc.,); (iv) legal position (such as, terms of prospectus, trustees and their responsibilities, systems for timely payment and for protection against forgery/fraud, etc.,);

(b) Financial analysis. This covers, accounting quality (over-statement/ understatement of profits; auditors qualifications; method of income recognition; inventory valuation and depreciation policies; off balance- sheet liabilities, etc.,); (ii) earnings protection (sources of future earnings growth; profitability ratios; earnings in relation to fixed income charges, etc.,); (iii) adequacy of cash flows (in relation to debt and fixed, and working capital needs; variability of future cash flows; capital spending flexibility; working capital management, etc.,); (iv) financial flexibility (alternative financing plans in times of stress, ability to raise funds; asset redeployment potential etc.,).

(c) Management evaluation. This covers (i) track record of the management, planning

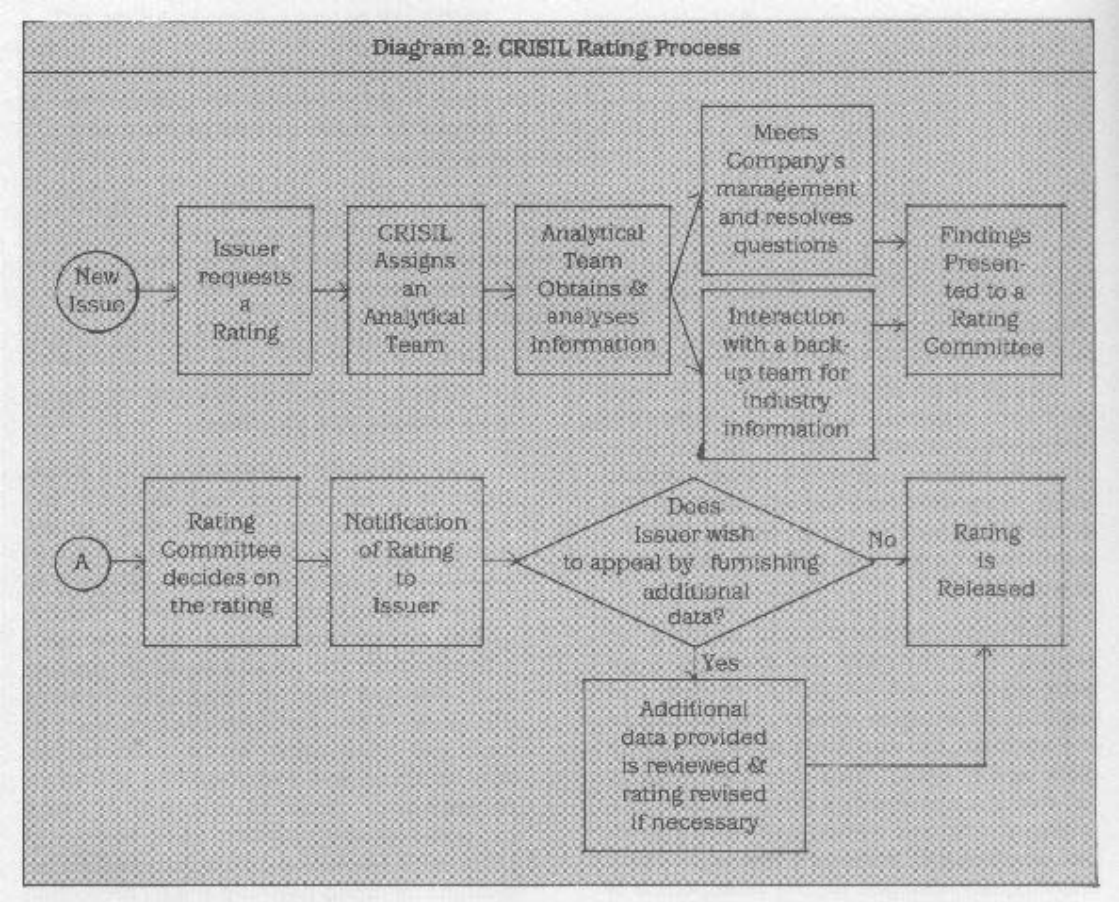


Diagram 2: CRISIL Rating Process
New Issue
Issuer requests a Rating
CRISIL Assigns an Analytical Team
Analytical Team Obtains & analyses information
Meets Company's management and resolves questions
Interaction with a back-up team for industry information
Findings Presented to a Rating Committee
A
Rating Committee decides on the rating
Notification of Rating to Issuer
Does Issuer wish to appeal by furnishing additional data?
No
Rating is Released
Yes
Additional data provided is reviewed & rating revised if necessary

and control systems; depth of managerial talent; succession plans; (ii) evaluation of capacity to overcome adverse situations; (iii) goals, philosophy and strategies. While all the above factors are considered for companies with manufacturing activities, the assessment of finance companies lays emphasis on the -following factors in addition to the financial analysis and management evaluation as outlined above.

(d) Regulatory and competitive environment. This covers (i) structures and regulatory framework of the financial system; (ii) trends in regulation, deregulation and their impact on the company.
(e) Fundamental analysis. This covers (i) liquidity management (capital structure; term matching of assets and liabilities; policy on liquid assets in relation to financing commitments and maturing deposits); (ii) asset quality (quality of the company's credit risk management; systems for monitoring credit; sector risk, exposure to individual borrowers; management of problem credits, etc.,); (iii) profitability and financial position (historic profits; spreads on fund deployment revenues on non-fund-based services; accretion to reserves, etc,); and (iv) interest and tax sensitivity (exposure to interest rate changes; hedge against interest rate and tax law changes).

The entire rating process takes between four to six weeks. CRISIL also plans to conduct equity research to provide information to investors and to guide them in their equity investment decisions. It also plans to provide additional information on companies to bankers and financial institutions and to perform payment record analysis to analyse the credit record of dealers as also their competence in meeting obligations (Mamta Suri, 1989).

The State Bank of India has decided recently that the leasing and hire purchase companies banking with it and wishing to borrow more than Rs. 50 lakhs must obtain a rating from CRISIL. The State Bank is insisting on the rating even if it is a smaller number of the consortium. The rating will be a one-time rating and a fresh rating will be insisted only when the borrower asks for a rise in Maximum Permissible Bank Finance (MPBF) (Chartered Financial Analyst 1989). The Union Government, in September 1990, cleared a proposal by the Industrial Finance Corporation of India (IFCI) to set up a second credit rating agency in the country to meet the requirements of companies based in the north (Economic Times, September 1990).

Approaches to Credit Rating
In the foregoing analysis, the meaning and scope of credit rating and how CRISIL rates an issue, was discussed. In this section, a narration of the usual approaches to the credit rating process and whether quantitative models can be used to carry out credit rating is given.
The approaches usually adopted for credit rating are: (i) implicit judgmental approach; (ii) explicit judgmental approach; and (iii) statistical approach.
Implicit Judgmental Approach
This approach rates a security by considering a broad range of factors, some of which may be quantified, and others not quantified. It is not necessary that all the factors considered should be specified. The factors covered are weighted and combined in an unspecified manner, and a credit rating is arrived at. The rating of equity issues by the periodical Capital Market is an illustration of the implicit judgmental approach. The factors considered by Capital Market (1986) are divided into six categories:
I. Promoters.

1. Industry house
2. Group companies (market price)
3. Group companies (EPS)
4. Existing company (market price)
5. Existing company (EPS)
6. Auditors qualifications
7. Experience
8. Qualifications

9. Age

II. Project

1. Product technology
2. Collaborators
3. Gestation
4. Location
5. Utilities
6. Labor
7. Cost of project
8. Cost of finance
9. Institutional appraisal
10. Other similar project

III. Prospects.

1. Consumer
2. Present market size
3. Future market size
4. Competitors
5. Marketing arrangements
6. Technology obsolescence
7. Future projects

IV. Government Policy:

1. Price control/subsidy
2. Import (OGL, etc.)
3. Taxation
4. Government attitude

V. Security Characteristics:

1. CCI consent
2. Secured/Unsecured
3. Interest
4. Capital appreciation
5. Dividend
6. Premium
7. Size of issue
8. Tax benefits
9. Liquidity

VI. Miscellaneous

Capital Market assigns a maximum of I 00 points, distributed among the characteristics mentioned above. Since there are about 40 sub criteria, the total of 100 points is divided among the sub- criteria at about 2.5 points per sub criterion. As a result no sub criteria is given undue weightage. Though all the criteria used for evaluation are spelt out, the way in which the criteria are weighted and combined to form a final score is not explicitly specified. An example of issue rating published by Capital Market (1990) is given below.

Company	Videocon VCR Ltd.	
Promoters	Videocon group in collaboration with Toshiba Corporation Japan	
Project	Manufacture of VCR/VCP including video tape deck mechanism with a capacity of 8 lakh numbers per annum.	
Cost of the project	Rs. 49.80 Crores.	
Present issue	Equity shares of Rs. 10 Each for Cash at par	4.45
	12.5% Secured redeemable partly convertible debentures of Rs. 250 each (Offered to public Rs. 418 crores)	15.25
	14% Secured Redeemable non-convertible debentures of Rs. 100 each issued to public	15.00
	Total	34.70
	Credit Rating: 53/100	

The periodical has also made the following observations to justify the rating assigned: -

* The company proposes to import most of the raw materials against yen payment till the company, s phased indigenisation materialises. With the bad balance of payments

position and the government's thinking on conspicuous consumption the venture is a bold bet; it has opted for a very high debt gearing of 5.43 times its equity; it has borrowed Rs.8.85 crores from Videocon International Ltd as unsecured loan; and the issue prospectus makes no mention of the schedule of the implementation of the project. Though according to the company sources, production would commence within a short time, the orders placed for machinery as shown under "material contracts" amount to only Rs.48 lakhs worth of yen.

Explicit Judgmental Approach

This approach involves the following: (i) A set of factors which are considered relevant for rating purposes, is defined; (ii) The weights which are to be assigned to these factors are also explicitly specified; (iii) For each of the factors, a quantitative assessment of the entity to be rated is made; and (iv) The weights are applied to the quantitative assessment and a numerical credit score or Index is arrived at.

The illustration given below shows the application of the explicit judgmental approach.

Illustration. A rating agency considers the following set of factors and their relative weights for rating a debt instrument issued by a company. The rater quantitatively assesses each of the factors listed above on a 0- I scale, and such assessment is based purely on the judgment of the rater. Combining the weights with the assessment made, the overall credit score is derived. Table 2 shows how the final score is arrived at.

Factor	Weight
Networth	7
Current ratio	5
Turnover	15
Profitability	20
Business risk	23
Financial risk	15
Managerial competence	15

Statistical Approach

In both the implicit judgmental and explicit judgmental approaches, the rating of a security is based on the subjective assessment of the rater and hence the final score arrived at could be biased. The statistical approach, in contrast uses a statistical method in selection of factors, the weights to be assigned to them and in the interpretation of scores. Though the judgment of the rater plays an important role in the initial selection of factors and model specification, the credit rating model that finally emerges is based on an objective process and statistical concepts.

The steps involved in the statistical approach are as follows: (I) A set of factors which are considered to be relevant for rating purposes is defined; (II) A sample of objects (in this case instruments already issued) is taken and based on historical experience, an "a priori" classification of these objects is made; (III) Using an objective statistical

method, the credit rating model is developed. This model shows the factors which are really relevant the relative importance of these factors and the manner in which they should be combined to determine the credit rating- (iv) The model developed is tested by scoring the sample of objects already gathered in order to determine the predicting power of the model.

Factor	Weight	Quantitative assessment	Weight X quantitative assessment
Networth	7	0.50	3.50
Current ratio	5	0.75	3.75
Turnover	15	0.60	9.00
Profitability	20	0.40	8.00
Business risk	23	0.50	11.50
Financial risk	15	0.80	12.00
Managerial competence	15	0.80	12.00
Overall Credit Score		= 59.75	

The scores as generated by the model are compared with the actual scores and inferences are drawn about the reliability of the model. Edward Altman, a leading investment banker in the US, has developed a Z- score model to predict corporate collapses. He has used the statistical technique of discriminant analysis for identifying the financial ratios which are most important for predicting corporate health and also for assigning weights to such ratios. The key ratios identified by him cover profitability, leverage, asset turnaround, and liquidity. Based on the analysis, the Z- score is arrived at. Research in the US has indicated that if the Z- score dropped below 1.8, the corporation would be heading towards bankruptcy (Economic Times, Jan. 1990). A brief note on discriminant analysis is given in Appendix 2.

The use of the quantitative models as under the statistical approach can help in reducing inconsistencies; that is, there is less chance for different ratings to be assigned by different ratings to the same instrument. Also, investors can use quantitative models to rate those privately placed debt issues for which no ratings are available. However, the quantitative models in exclusion may not always lead to a correct rating as a number of subjective, judgmental and qualitative factors have to be considered in a rating process. A rater can, therefore, use quantitative models to test his judgment and to reduce inconsistencies in rating.

Sovereign Rating

In recent times, the credit rating of countries or sovereign rating has assumed a great importance. While rating agencies, such as Standard and Poor, Japan Centre for International Finance and the London based Economist carry out periodical studies of the creditworthiness of various countries, lenders and exporters use such reports to fine-tune the rates at which funds are made available to the borrowing countries and to add clauses -of varying stringency in the export sales agreements. The higher the risk associated with a country, the higher the margin charged above the bench-mark

rates, such as the LIBOR (London Inter-bank Offered Rate) or the long time prime at which financial institutions are willing to lend or borrow at a particular point of time (Financial Express, May 1990). The Economist follows the explicit judgmental approach in sovereign rating. The factors considered and the maximum points assigned to each of these factors (to reflect their relative importance) are given in table.

Sovereign Rating: Factors of

Factor	Maximum Points
Economic	
FallingGDP	8
Inflation	5
Capital flight	4
Foreign debt	6
Low food output	4
Commodity dependence	6
Political	
Bad neighbours	3
High authoritarian	7
Staleness	6
Illegitimacy	9
Generals in power	6
War	20
Social	
Urbanisation	2
Islamic fundamentalism	4
Corruption	6
Ethnic tension	4
	100

For each country a score is assigned for each factor within the range of zero and the maximum possible points. The scores for all the factors are added to get the aggregate risk score and the higher the score, the greater is the risk associated with the country. The countries, based on the risk scores are also classified into: Hyper-risk, very high risk, high risk- medium risk, and low risk categories. In the 1986 risk ranking of countries the Economist classified India as a medium risk country with a risk score of 35. In the same year, the Japan Centre for International Finance (JCIF) gave the rating of G to India (Bagchi, 1986). According to JCIF, an "A" rated country is fully capable of servicing existing debt and will be able to continue to do so for the next four years. It will also be able to meet any fresh fund requirements. "B" rated countries are also fully capable of servicing the existing debt but while "A" rated countries have the capacity to service a higher level debt than the existing, the same cannot be said of "B" rated countries. The "C" rated countries are also capable of making current debt payments but could have borrowing or debt servicing problems if global financial conditions change. Countries which could have imminent financing problems are rated by JCIF as "D", and those countries which have already run into problems in servicing their external debt are rated as "E".

Of late, the credit rating of India has taken a beating. In May 1990, the rating agency of the US, Standard and Poor, noted that the long-term credit rating of India is likely to be "BBB" (Financial Express, May 1990). The rating of "BBB" implies that the country's borrowing capacity is poor. According to the rating agency, the country is extremely vulnerable to changes in world oil prices and due to the unfavorable balance of payments situation, the country is relying more on commercial debt which could further expose it to international market pressures. Other factors causing the low rating are high monetary expansion leading to increased inflation which exerts pressure on balance of payments, and the low rate of investment in the country.

Conclusions

Credit rating in recent times is being looked upon as an important investment advisory function. In countries with highly developed markets, such as the US, and Japan, though there is no statutory requirement to have the securities rated, as high as 90 per cent of the securities floated are voluntarily rated due to the pressure exerted by investors and bankers. In India, a beginning has been made with the establishment of CRISIL and the RBI insisting that all commercial papers prior to their issue must be rated. With the growth in volume and depth of capital markets and the increasing knowledge and awareness of the investors, it can be expected that voluntary credit rating would be on the increase.

Appendix I

CRISIL'S CREDIT RATING SYMBOLS FOR SECURITIES OTHER THAN DEBATURES (Based on CRISIL'S Booklet on Rating)

Rating Symbol	Interpretation
Fixed Deposits	
FAAA-High safety (F-AAA)	This rating indicates that the degree of safety regarding timely payment of interest and principal is very strong.
FAA- High safety (F-AA)	This rating indicates that the degree of safety, timely payment of interest and principal is strong. However, the relative degree of safety is not high as for fixed deposits with "FAAA" rating.
FA - Adequate safety	This rating indicates that the degree of safety regarding timely payment of interest and principal is satisfactory. Changes in circumstances can affect such issues more than those in higher rated categories.
FB - Inadequate safety	This rating indicates inadequate safety of timely payment of interest and principal. Such issues are less susceptible to default than fixed deposits rated below this category, but the uncertainties that the issuer faces would lead to inadequate capacity to make timely interest and principal payments.
FC - High Risk	This rating indicates that the degree of safety regarding timely payment of interest and principal is doubtful. Such issues have factors at present that make them vulnerable to default. Adverse business or

	economic conditions would lead to lack of ability or willingness to pay interest or principal.
FD - Default	This rating indicates that the issue is either in default or is expected to be in default upon maturity.
CRISIL may apply '+' (plus') or '-' (minus) signs for rating from "FAA' to "FC" to indicate the relative position within the rating category of the company raising Fixed Deposits.	
Commercial Paper:	
p - 1	This rating indicates that the degree of safety regarding timely payment on the instrument is very strong.
P – 2	This rating indicates that the degree of safety regarding timely payment on the instrument is strong. However, the relative degree of safety is lower than that for instruments rated "P-1".
P – 3	This rating indicates that the -degree of safety regarding timely payment on the instrument is adequate; however, the instrument is more vulnerable to the adverse effects of changing circumstances than an instrument rated in the two higher categories.
P - 4	This rating indicates that the degree of safety regarding timely payment on the instrument is minimal and it is likely to be adversely affected by short-term adversities or less favourable conditions.
p - 5	This rating indicates that the instrument is expected to be in default on maturity or is in default.
CRISIL may apply '+' (plus) sign for ratings from 'P- I' to 'P-3' to reflect a comparatively high standing within the category.	

Appendix 2

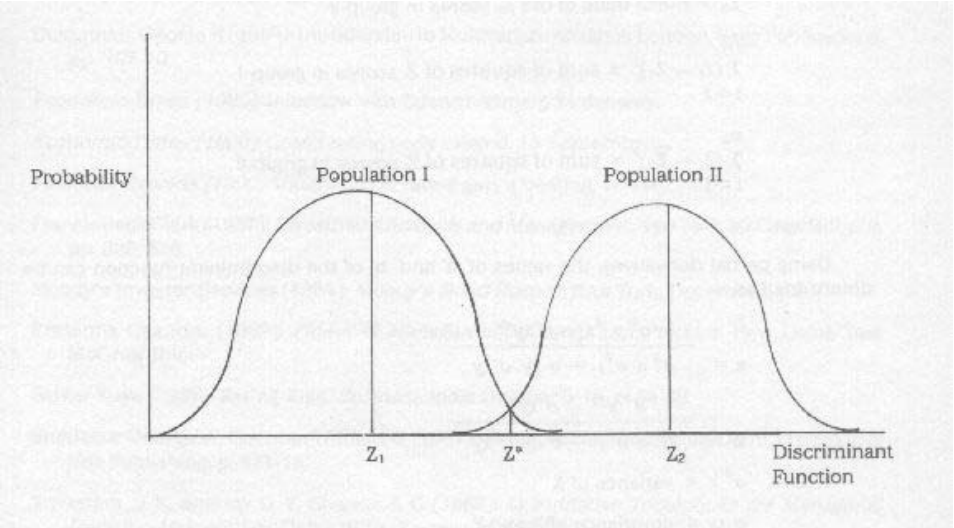
***DISCRIMINANT ANALYSIS TECHNIQUE**:'*

The discriminant analysis technique is used in those cases where items have to be classified into one of two populations on the basis of one or more criteria. Examples of situations where the discriminant analysis can be used are,

1. Classification of customer accounts into two classes, such as good or bad on the basis of criteria such as current ratio and return on investment of the customers' business.
2. Classification of companies into two classes such as sick and non-sick on the basis of criteria, such as profitability ratios, leverage ratios and cash flow coverage ratio.
3. Classification of students into two categories such as likely to pass an engineering course and not likely to pass the engineering course on the basis of intelligence tests, aptitude tests etc.

In each of the examples given above a discriminant function must be established which can be used to classify. the customer accounts or companies or students into the two classes. Further, the cutoff point for the discriminant function must be established in such a way that the probability of wrong classification is minimised.

The cutoff point may be visualised as under



In the above figure though the distributions overlap and there are chances of misclassifications, at the cutoff value represented by the point Z*, it can be seen that the misclassification is minimised.

The discriminant analysis makes the following assumptions:

1. There are two discrete groups
2. Two selected variables would be combined in a linear relationship and the linear function of the form, Zi = aXi + bYi would be used for discriminating between the two discrete groups
3. The two selected variables arise from multivariate normal populations. Though the means of the two variables in each group would be different, the variance/covariance matrix is the same for each group.

The discriminant function of the form Zi = aXi + bYi can be be obtained by maximising the ratio given below:

The discriminant analysis makes the following assumptions:

(i) There are two discrete groups

(ii) Two selected variables would be combined in a linear relationship and the linear function of the form,

$Z_i = aX_i + bY_i$ would be used for discriminating between the two discrete groups

(iii) The two selected variables arise from multivariate normal populations. Though the means of the two variables in each group would be different, the variance/covariance matrix is the same for each group.

The discriminant function of the form $Z_i = aX_i + bY_i$ can be be obtained by maximising the ratio given below:

$$G = \frac{(\bar{Z}_1 - \bar{Z}_2)^2}{\sum_{i=1}^{n_1} (Z_i - \bar{Z}_1)^2 + \sum_{i=1}^{n_2} (Z_i - \bar{Z}_2)^2}$$

Where $\bar{Z}_1$ = mean value of the Z_1 scores in group 1

$\bar{Z}_2$ = mean value of the Z_2 scores in group 2

$\sum_{i=1}^{n_1} (Z_i - Z_1)^2$ = sum of squares of Z_i scores in group 1

$\sum_{i=1}^{n_2} (Z_i - \bar{Z}_2)^2$ = sum of squares of Z_i scores in group 2

Using partial derivatives, the values of 'a' and 'b' of the discriminant function can be determined as,

$$a = \frac{\sigma^2 y . {}^{d}x - \sigma xy . {}^{dy}}{\sigma^2 x \, \sigma^2_y - \sigma xy . \sigma xy}$$

$$b = \frac{\sigma^2 x . {}^{dy} - \sigma xy . {}^{dx}}{\sigma^2 x \, \sigma^2_y - \sigma xy . \sigma xy}$$

Where, $\sigma^2 x$ = variance of X

σxy = covariance of X and Y

σ^2_y = variance of Y

dx = difference between the mean values of X for the two groups (group 1 and group 2)

dy = difference between the mean values of Y for the two groups.

For choosing the cutoff point for the discriminant function, the steps are as follows:

1. The Zi value for all observations as delivered from the discriminant function must be determined and arranged in an ascending order.
2. Identify where the observations from two groups overlap and consider the midpoints of adjacently ranked observations as possible cutoff scores.
3. Choose that cutoff score for which the number of misclassifications are minimized.

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